Basel III: the Net Stable Funding Ratio

To the Basel Committee

Please find enclosed remarks from the Danish Government on the consultative document on the Net Stable Funding Ratio.

If you have any question or would like some further information, do not hesitate to contact the ministry.

Sincerely,

Henrik Sass Larsen
Minister for Business and Growth
NOTE

Written comments on BCBS consultative document on Basel III: the Net Stable Funding Ratio

The Danish Government appreciates the opportunity to comment on the consultative document on the Net Stable Funding Ratio (NSFR).

In general, we support the proposed revisions to the Basel framework’s NSFR. In that regard we find it positive that the framework contains an approach of reducing cliff effects within the measurement of funding stability by allowing for a 50 percent Available Stable Funding factor on funding with residual maturity of less than one year.

However, we do have a specific comment regarding the treatment of certain covered bonds with a statutory soft-bullet structure as a stable funding source in the NSFR standard.

In Denmark the terms of adjustable-rate loans secured on real property and granted by mortgage-credit institutions is typically 30 years. Some of these loans are financed by bonds with a shorter term than the maturity on the loan, e.g. one-year or three-year bonds. This means that the loans must be refinanced at regular intervals potentially exposing the mortgage-credit institution to refinancing risk.

In relation to the NFSR, which focuses on available stable funding with maturity longer than one year, this can create a challenge for the mortgage-credit institutions, as much of their funding will not be considered sufficiently stable.

The Danish parliament has in that regard recently passed an amendment to the covered bond legislation, which deals with the refinancing risk faced by mortgage-credit institutions. In the future, the maturity date of bonds related to loans that may be refinanced at regular intervals can be extended in certain circumstances. This means that the refinancing risk will have to be borne by the investors, not the mortgage-credit institutions.

Specifically, the bill requires that conditions for these bonds must stipulate that if an auction fails or the interest rate for bonds with a term of up to two years at the refinancing becomes more than five percentage points
higher than the interest rate the previous year, the bond will be extended by one year at a time (soft-bullet structure).

I think it is fair to say that this amendment is quite a novelty in financial regulation. It makes Denmark the first country to deal with the refinancing risk of covered bonds in a systematic way.

The Act has entered into force on 1 April 2014 for loans financed with bonds with a term of up to 12 months and it will enter into force on 1 January 2015 for the remainder.

As described in the consultative document on the Net Stable Funding Ratio the key intention of the Net Stable Funding Ratio standard is to require banks to maintain a sustainable funding profile by having a sufficient amount of stable funding in relation to the composition of their assets and off-balance sheet activities. The stable funding should be reliable over the NSFR time horizon of one year and thus the maturity of the funding is an important factor in assessing its degree of stability.

Underlying this point 17 in the consultative document on the Net Stable Funding Ratio states;

"When determining the maturity of an equity or liability instrument, investors are assumed to redeem a call option at the earliest possible date. For funding with options exercisable at the bank’s discretion, banks should assume that they will be exercised at the earliest possible date unless the bank can demonstrate to its supervisor’s satisfaction that the bank would not exercise this option under any circumstances..."

With that in mind we advocate that for liability instruments containing a legal statutory fixed trigger option indicating that the maturity of the instrument will be extended at maturity, if the instrument is not able to be refinanced in the market, the labelling of the instruments in an NSFR context should take extension options like this into account. These instruments, typically denoted soft-bullet structures, precisely include options, effectively eliminating the refinancing risk that the NSFR tries to take into account. Hence, depending on the term of the extension, they should be treated as a source of stable funding. Naturally the terms of the extension option must be sufficiently clear, so as to ensure that the option will be exercised with certainty, in the case where the instrument is not able to be refinanced in the market.

In this context, bonds like Danish covered bonds regulated by the new amendment to the covered bond legislation should be eligible as stable long-term funding in the NSFR since these bonds will either be refinanced under normal circumstances at an auction or by extension if the refinancing fails. This means that the refinancing risk of the issuing institution is removed, and consequently there is no mismatch between the
maturity of the adjustable-rate mortgages and the funding of these loans. Therefore we assess that such bonds will fulfil the requirements of long-term stable funding in the NSFR.