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## Response to the Basel Committee on Banking Supervision consultation on internal models

21 June 2016

The Danish Bankers Association, the Association of Danish Mortgage Banks and the Danish Mortgage Banks' Federation appreciate the opportunity to comment on the Basel Committee's consultative document on reducing variation in credit risk-weighted assets - constraints on the use of internal model approaches.

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### Key messages

- We understand and support regulatory efforts to restore confidence in internal models. We do, however, strongly object to the approach taken by the Basel Committee predominately relying on reducing the risk sensitivity of the capital adequacy framework for credit risk by restricting (or completely eliminating) the use of internal models - in some cases also for exposures where highly reliable data and modelling techniques are available.
- We are particularly concerned about the proposal of the Basel Committee for setting a floor on risk weighted assets based on the standardised approach.
- Floors are, in our opinion, inconsistent with a risk-based approach. At best they impede risk-sensitivity - at worst they induce unhealthy incentives and lead to severe mis-allocation of resources.
- Furthermore, the floors and proposed migration of certain exposure types to much less risk sensitive approaches will leave insufficient room to capture national and/or jurisdictional specificities.
- We also question the genuine need for the proposed floors as the expected leverage ratio requirement will function as a backstop to capture unsustainable low capital levels. In short imposing two backstop measures seems unnecessary and will increase complexity.
- The Danish financial sector has a relatively large share of low risk exposures on the balance sheet. Hence the proposed capital floor will be binding even if floors are set in the low end of the indicated range based on the revised standardised approach issued for consultation by the Basel Committee on 11<sup>th</sup> March 2016.
- The current proposal would therefore – if implemented – result in a very significant increase in risk weighted assets and capital requirements for Danish banks and specialised mortgage banks. An increase that would not reflect the underlying risk of the loan portfolios.

- This will no doubt have a significant impact on the supply and pricing of funding to households and corporates. An impact that would not be justified by actual financial stability concerns. As such the proposal is in direct conflict with policy makers efforts to support economic growth.
- It is central to maintain risk sensitivity at the core of the capital requirement framework. This preserves the link between regulatory capital and banks internal credit risk management and pricing systems, and ensures that required capital levels are aligned with risks associated with local markets conditions and business choices.
- Confidence in internal models is best achieved by addressing the identified problems with internal models directly. Focus should therefore be on maintaining a risk based approach where abundant, good quality data and robust modelling techniques are available.
- We acknowledge that some low default portfolio exposures can be challenging in terms of quality of data. But instead of removing the possibility to use the A-IRB or F-IRB altogether, regardless of data and modelling techniques actually available, we recommend setting up more stringent criteria for assessing modellability based on best practice methods. This should allow the supervisory authorities to determine to what extent a bank's portfolios are eligible for using either A-IRB, F-IRB or the Standardised Approach.
- Where there is a scarcity of default and loss data, we would urge the national or regional authorities to share pooled datasets, when available, with banks.
- We thus support further strengthening and harmonisation of modelling assumptions and parameter definitions and setting up stringent criteria for minimum data requirements to determine whether a parameter or portfolio is suitable for IRB modelling. Specifically we recommend considering the important work underway in this area at the European Banking Authority (EBA).

In the following we comment on specific proposals in the consultations document that are of particular importance for Danish banks and mortgage banks.

### **Application of output and parameter floors**

We are against setting global minimum values for parameter estimation (parameter floors) and output floors based on the Standardised Approach. This is a poor substitute for the pursuit of higher standards for models in order to enhance confidence in the IRB approach.

Applying input/output floors instead of addressing the real problems within the IRB models directly has a wide array of unfortunate consequences. The link between banks regulatory capital and internal credit risk management is destroyed and banks will have incentives to move away from sound risk measurement techniques. The risk appetite and risk management will be distorted leading to a shift to higher risk exposures which are unaffected by the parameter floors. Parameter floors also undermine the investment,

which banks have made in developing best practice risk measurement techniques and disincentive banks from further investing in these practices.

According to the consultative document the combined effects of the proposed revised Standardised Approach and constraints on the use of internal models approaches for credit risk is not intended to significantly increase overall capital requirements. However, if a floor on risk weighted assets based on the proposed Standardised Approach is introduced, even if calibrated in the lower range of the 60% to 90% span the outcome would be large increases in overall capital requirements for Danish banks and mortgage banks, that operate in a comparably safe banking environment with low risk weights on real estate and corporate. Our estimates indicate an increase of more than 50% if the floor is set at 80%.

This significant effect is primarily a result of the introduction of the new design of a REA floor, but applying the revised standard method (SA) relative to the former versions will also contribute.

Such increases would not reflect the underlying risk of the loan portfolios, but will nonetheless have a significant impact on the supply and pricing of retail and commercial real estate financing. Furthermore, it could induce the credit institutions affected by disproportionate increases in capital requirements that do not reflect the risk of their current business model to engage in higher risk businesses and relieve their balance sheet of low risk loans. This would, we believe, not promote financial stability.

Should the parameter floors be maintained in the final proposal, we suggest that they be applied at portfolio level, as opposed to the proposed exposure level. That would preserve some risk differentiation for low risk exposures within the portfolio and improve incentives within banks to retain and manage low risk exposures within a portfolio. However, parameter floors will in any case be problematic for banks and specialised mortgage banks.

### **Treatment of mortgage loans**

The proposed output and parameter floors will particularly affect mortgage loans in Denmark where the actual level of losses and impairments from mortgage lending are in the low end of the distribution in both a European and global context. This is to a large extent due to jurisdictional specificities under which creditor protection is extremely strong in Denmark and foreclosure processes are highly efficient and where borrowers are subject to full recourse liability, which is reflected in low loss rates on mortgage lending.

These characteristics make specialised Danish mortgage banks – which by law are constrained in their business model only to extend mortgage loans within certain LTV limits - highly vulnerable to the proposed floors.

Loan impairments have been less than 1% of total lending by Danish specialized mortgage banks, including commercial lending, even during the worst crisis in the 1930s. During the recent financial crisis – following considerable declines in property prices and GDP – the loan loss level, including commercial lending, has been modest at 0.2% annualized. Further details on loan impairments are attached in the Annex.

The risk weights implied by the Danish loss experience are both in absolute and in relative terms very low compared to the proposed risk weights in the revised Standardised Approach. Generally estimated risk weights for Danish retail mortgages calculated using the IRB formula (including the LGD floor of 10% at portfolio level and LGD downturn add on) show average risk weights in the area of 13-17%. This is far below the risk weights under the Standardised Approach which start at 25% in the lowest LTV bucket.

An output floor based on the Standardised Approach or the introduction of parameter floors in the IRB approach would therefore effectively disconnect any link between the risk of Danish Mortgage loans and the required capital levels in the Danish market. This seems particularly unsatisfactory because there is an abundance of good quality data supporting IRB models.

Mortgage loans are on-balance sheet assets of mortgage banks. They are non-transferable and, consequently, remain on the balance sheet of the lender throughout their loan period irrespective of their performance. In other words non-performing loans are not removed from the balance sheet of the mortgage bank as they may be in other markets.

In our assessment the comprehensive, complete, and detailed records of all borrower defaults and losses incurred form a solid basis for the calibration of advanced IRB models within all segments including income producing real estate, cf. section below on specialised lending.

For these assets risk weights should not be set on the basis of the Standardised Approach as this approach is not calibrated to the actual performance of the assets and therefore is a poor fit. In general, the Standardised Approach should not be considered a reference point but rather a fall-back solution for portfolios where the national authorities assess that the data and modeling techniques are inadequate for the satisfactory calibration of IRB models.

Our estimates indicate an increase in capital requirements for Danish mortgage loans of around 50% if the floor is set at 60% and 100% if the floor is set at 80%. This will have a serious impact on the viability of the business model on which specialised Danish mortgage banks is based. We therefore urge the Basel Committee not only to consider the objective of not in general giving rise to significant increases in capital requirements, but also to consider that certain business models and business activities of credit institutions or certain asset classes are not adversely affected by the new standards.

### **Treatment of specialised lending exposures**

The proposal to remove the IRB option for specialised lending (SL) seems particularly unjustified for real estate where the prospect of the repayments of the loan depends materially on the cash generated by the property. This type of property could potentially be classified as SL according to the criteria for specialised lending exposures set out in the BCBS's revised framework International Convergence of Capital Measurements and Capital Standards from 2004 (Basel II) – para 219 and para 226.

Danish banks and specialized mortgage banks have an abundance of data on various segments of office buildings and rental housing, including default data, and a long track record of approved estimation techniques for PD as well as LGD. The significant amount of data makes it possible to take account of the potential correlation between PD and LGD.

We find that the concept of specialised lending is unclear and should not cover homogenous and common residential or commercial real estate exposures where abundant and reliable data is available, even if they share some of the features with specialised lending. The specialised lending approach for income producing real estate should only be applied when real estate is constructed for more specific income producing purposes where tailor-made lending conditions, including control features, are the norm.

Losses for Danish mortgage lending to private rental housing, public housing and office buildings have been very low even in periods of financial distress. For the last 40 years the losses on private rental housing have been below 0.5% except for a few years. Further details on losses are in the annex.

The existing SL slotting method does not appear to be calibrated to reflect low loss experiences of income producing residential real estate that could potentially be classified as SL. For most such exposures an SL classification would result in very substantial increases in capital requirements which may not reflect the risk of the specific exposure.

### **Treatment of corporate exposures**

As with the treatment of mortgage loans, our main concern regarding exposures to corporates is the output floor. This will, in particular, affect exposures to mid-cap corporates which are rarely rated and therefore will be assigned the risk weight of 100% under the Standardised Approach.

In order to ensure a level playing field with banks in jurisdictions that do not allow the use of external rating, it is imperative to put in place a solution that assigns a 75% risk weight to exposures to unrated corporates that comply with the conditions set for the category of investment grade in the Standardised Credit Risk Assessment Approach (as described in the revised Standardised Approach).

Even if the output floor is not introduced, due consideration should be given to the combined effect of the IRB constraining proposals for corporate exposures and the revised Standardised Approach for credit risk. The proposals are intertwined as a result of the proposed removal of the use of the advanced IRB Approach for larger corporates with an annual turnover above EUR 200 million, and the prescribed use of the Standardised Approach for corporates that are part of a group with consolidated assets above EUR 50 billion.

We do not see the rationale behind the differentiated treatment of large corporates with consolidated assets larger than EUR 50 billion threshold vis-à-vis all those large corporate belonging to groups with revenues greater than EUR 200 million which can use F-IRB. If PD estimations can be performed, the exposures should only be migrated to the F-IRB model.

According to the proposal all exposures to banks and other financial institutions will be subject to the Standardised Approach. Again this treatment is not in line with the actual risk and the loss data. We find that the data available for these type of exposures - in particular for other financial institutions - is sufficiently strong, at least to allow the F-IRB model to be used.

The severely increased credit conversion factors for undrawn corporate facilities proposed in the consultation for the revised Standardised Approach will have a large impact on capital requirements for exposures to corporates as well as banks and other financial institutions. This will be either caused directly through the use of the Standardised Approach or the foundation IRB Approach or indirectly through the proposed CCF parameter floor for exposures to smaller corporate where the Advanced IRB Approach can be used. If the proposal is implemented as it stands, corporate and financial counterparties would see their risk-weights increased significantly. An increase which would clearly be out of proportion, given that the main objective of the proposal is to reduce "undue variation" in the capital treatments of similar exposures across banks using the IRB Approach.

If the proposed differentiation of the prescribed methods based on the size of the corporate is maintained, we strongly recommend that the definition of the threshold is revised. Even though most parent companies in very large corporate groups are rated by rating agencies, this is rarely the case for subsidiaries of such groups. In order to limit the distortionary effects and ensure consistency, we recommend treating the subsidiaries in line with the level of support they receive from their parent company. If the parent company has not issued support or guarantees for subsidiaries allowing them to use the rating of the parent company, banks should be permitted to evaluate the subsidiary on a stand-alone basis and use the approach otherwise prescribed for groups with total assets or revenue of similar size.

Yours faithfully



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ANNEX

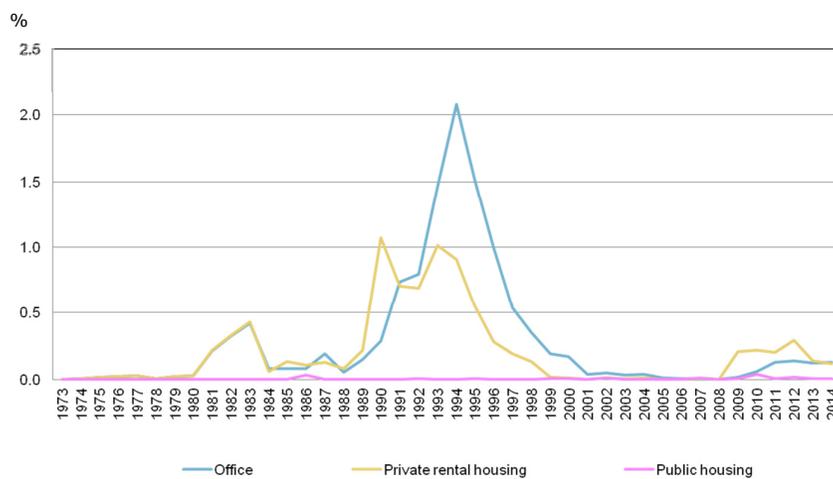
**Loan impairments for banks and mortgage banks**



Note: In 1990, the principles governing impairments in mortgage banks were changed. Going forward impairments should be made on likely losses and not just on certain losses as had been the case up until 1990. The data point for 1990 according to the new principles is 1.36%, however the Association of Danish Mortgage Banks have inserted 0.7%, which would be the data point according to the previous principles.

Source: "Pengeinstitutter, kredit og konjunkturer", Abildgren, Kim et al. in Kvartalsoversigt 2. kvartal 2013, Danmarks Nationalbank based on data from Danmarks Statistik and Finanstilsynet

**Losses for Danish mortgage lending to different property types**



Note: Figures from 1973 to 1988 are based on mortgage banks reporting to the Association of Danish Mortgage Banks. Figures from 1989 to 2014 are from the Danish FSA.

Source: Danish FSA and Association of Danish Mortgage Banks