Realkreditrådet
ASSOCIATION OF
DANISH MORTGAGE BANKS

Comments on EBA's draft guidelines for common procedures and methodologies for the supervisory review and evaluation process under Article 107 (3) of Directive 2013/36/EU

Q1. Do the guidelines specify the SREP process sufficiently? Are there areas where the EBA should aim for greater harmonization, or where more flexibility would be appropriate?

While we are in favor of increased consistency and quality of supervision it is of paramount importance, that such efforts duly respect and serve the diverse landscape of financial business models. Appendix 1 includes examples of specific issues to be adresses with respect to Danish mortgage banks.

Tools of harmonization

In general, peer-group analysis, clearly being a powerful tool of harmonization, quite naturally is endorsed in the guidelines. Yet, peer-group analysis could prove devastating to ill-categorized institutions.

Notably, the risk and potential adverse consequences due to inappropriate groupings of institutions, by virtue of peer-group analysis, further would be magnified, if applied across regions/nations. All else in concert, application of quantitative benchmarking for peer-group analysis, also could further amplify such unintended effects.

Enhanced supervisory scope

Another crucial aspect which needs to be addressed is the decision to link the on-going supervision with the recovery and resolution regime. Inevitably this decision enhances the potential impact of the outcome of the SREP, due to the intentions and potentially far-reaching consequences of the latter regime. In practice, the supervisory scope is expanded into areas within strategic planning, organization and general managerial decision making.

Generally speaking, we are uneasy in enhancing supervisory assessments beyond regulatory compliance, especially in combination with the far reaching supervisory measures available for remediation. In our view, the viability of, operating and compliant, financial business models most effectively are assessed and regulated by the general market forces.

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Risk of standardization

A law of regulation seems to be, that the more severe the consequences a piece of regulation might induce, the higher the risk, that the regulation in practice becomes normative to a non-desirable degree.

Therefore, great care should be taken that the SREP guidelines do not, directly or indirectly, impose the same (few) "optimal" business structures to all members of the broad and diverse population of European financial institutions.

The SREP guidelines take its starting point in the recently implemented- or coming regulatory framework - with a view to add-ons. Currently, considerable resources are allocated in the financial sector in adapting to the new prudential requirements.

On this backdrop we strongly suggest, that the SREP guidelines should await the outcome of the recently adopted regulation, before looking into additional measures and guidelines. In example, new monitoring requirements should be modeled within the boundaries of available information in the form, and aggregation as specified in COREP/FINREP.

Appendix 1

Examples of issues to be addressed specifically with respect to Danish mortgage banks.

- Funding risk

  In the assessment of the inherent funding risk to the financial institution (page 130) it is detrimental to Danish mortgage banks, that the principle of matching where all loans are matched with certain bonds, to which all Danish mortgage banks must adhere, is appropriately acknowledged. Even for Danish adjustable-rate mortgages funding risk is minimal, due to recent Danish legislation requiring if the refinancing fails the bonds will be extended by one year at a time.

  Similarly, these basic principles of the Danish Mortgage Model, applying immediate, full and automatic transmission of all funding costs to the borrowers, need to be appropriately addressed, when assessing the risk to the institution's cost of funding.

- Leverage

  Given the low risk and low return properties of the Danish Mortgage Model, it is essential to Danish mortgage banks to reap the benefits of scale. Therefore, Danish mortgage banks, basically, are conflicting with the concept of a simple leverage ratio - especially if applied universally within European financial institutions. Correspondingly, Danish mortgage banks will score very low on the assessment of the risk of excessive leverage, as described on page 118-119 in the draft guidelines. It therefore crucial, that the properties of the Danish Mortgage Model are taken into consideration when assessing the leverage risks of Danish mortgage banks.

- Concentration of funding sources and dependency on wholesale funding

  By construction, Danish mortgage banks only funds mortgage lending through wholesale funding. Danish mortgage banks are not allowed to hold deposits. Actually, the absence of diversification on the funding side enhances the security of Danish Mortgage Model, while at the same time failing, when assessed strictly with respect to the risk of concentrated funding sources - especially in the light of the post-crisis focus on a reduction on dependency on wholesale funding. For example, the Danish mortgage banks were able on a daily basis to issue and sell large volumes of covered bonds during the financial crisis in 2008-2009.

  Therefore, it is vital to Danish mortgage banks, that the concentrated funding side of the mortgage banks is acknowledged as strength rather than a risk.

- Asset concentration

  In essence, our remarks regarding the concentrated funding side of Danish mortgage banks apply in the same manner with respect to the very concentrated asset side of the Danish mortgage banks. By law Danish mortgage banks only are allowed to grant mortgage loans - and only funding by issuing covered bonds.

Q2. Do you agree with the proportionate approach to the application of the SREP to different categories of institutions? (Title 2)

No comments.

Q3. Are there other drivers of business model / strategy success and failure that you believe competent authorities should consider when conducting the BMA? (Title 4)

As stated above, in general, we are concerned of the enhancement of supervisory assessments beyond regulatory compliance. In addition, another concern must be addressed.

Low risk and low return financial business models have been, and still are, the very backbone of housing financing in several parts of Europe. The Danish mortgage model is an example of a low risk and low return financial business model.

Given the focus on profitability when conducting the BMA, cf. the presentation slides from the public hearing of the draft guidelines for SREP, it is paramount that low risk/low profit business models are acknowledged and treated in a correct manner. Otherwise, the consequences could be detrimental to European housing finance

Q4. Does the breakdown of risk categories and sub-categories proposed provide appropriate coverage and scope for conducting supervisory risk assessments? (Title 6)

The proposed breakdown of risk categories and sub-categories in general seems appropriate.

Given the fact, that institutions currently are striving to comply within the risk framework outlined in CRD/CRR, it is key that institutions become subject to appropriate phasing-in arrangements for mitigating potential risk-exposures disclosed by the application of risk frameworks different from the CRD /CRR framework.

Accordingly, we strongly agree that assessments of risk, based on alternative risk categories, must be appraised within the context of the business model and the total risk landscape of the institution in question.

Moreover, the benefit of an alternative breakdown of risk categories carefully should be weighted with respect to the potential implementation- and production costs of reporting - and thus managing - risks across alternative categories. As stated above, ideally new monitoring requirements should be modeled within the boundaries of available information in the form, and aggregation as specified in COREP/FINREP.

Q5. Do you agree with the use of a standard approach for the articulation of additional own funds requirements to be used by compete authorities across the Union? (Title 7)

Harmonization within supervisory requirements, both with respect to communication and proportionality of measures, benefits transparency of regulatory discipline, and assessment, within financial institutions in the EEA. This should be beneficial to the markets and the society in general. Nonetheless, we must reiterate, the importance of rooting such requirements within a supervisory analytic framework which is equally harmonized and meticulously adjusted to embrace, and correctly assess, the diversity of financial European business models.

Concluding on the example of TSCR articulation (page 117), the acknowledgement of own funds to cover Pillar 2 capital requirements depicts an area of the draft guidelines which require further adjustments.

<u>Acknowledgement of capital own funds to cover Pillar 2 capital requirements</u>

In article 339 of the draft guidelines specify that competent authorities shall set a composition requirement for the additional own fund requirement under Pillar 2 of at least 56 % CET1 and 75 % Tier 2 in line with the Basel III requirements (4.5% CET1; 6% T1 and 8% total capital).

In the example of TSCR articulation (page 117) and OCR articulation (page 118) it is unclear whether the requirements for Additional Tier 1 instruments (44 %) and Tier 2 instruments (25%) can be met by the Additional Tier 1 instruments and Tier 2 instruments with additional trigger features for write downs or conversion to equity, which have been approved as eligible to cover Pillar 2 capital requirements according to Regulation (EU) No 575/2013 by the competent authorities in some member states. It must be clearly stated, that the before mentioned instruments are eligible to cover the Pillar 2 capital requirements.

In the case that the draft guidelines actually intent to follow a different approach than outlined, by the competent authorities in some member states, we would deeply regret such intentions. Such ruling would severely influence institutions who have already issued such instruments and be a clear act of a surplus of harmonization. Moreover, Additional Tier 1 and Tier 2 instruments with additional trigger features which have been recognised by competent authorities to cover Pillar 2 capital requirements should, at least, be protected by a grandfathering clause. The deferred implementation date until 1 January 2019 would not be sufficient because of the long effective maturity of many such issued instruments”

Q6. Do you agree that competent authorities should be granted additional transition periods for meeting certain capital and liquidity provisions in the guidelines (Title 12)?

We support the granting of transition periods for meeting certain capital and liquidity provisions. On the same note, transition periods and observation/assessment periods should be used extensively, when imposing regulatory requirements, to facilitate a balanced use of supervisory measures.