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## Revision to the Standardised Approach for credit risk

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The Danish Bankers Association, the Association of Danish Mortgage Banks and the Danish Mortgage Banks' Federation appreciate the opportunity to comment on the second consultation paper on a revised Standardised Approach for credit risk.

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First of all, we would like to thank the Committee for accommodating industry concerns over several of the proposals in the first consultative document. Overall, with few exceptions, the second consultative document represents a significant improvement compared to the first consultative document.

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In some areas, however, there remain significant problems in the revised proposal, some of which also affect Danish banks and mortgage banks, for example excessive risk weights for unrated, mid cap corporates in jurisdictions that allow the use of external ratings, uncertainty regarding scope and depths of the due diligence requirement, the currency mismatch add on for corporate exposures and the severe increase in risk weights for off-balance sheet items. These problems, as well as other important issues, are addressed in detail in the responses from the European Banking Federation and the European Mortgage Federation, which we support.

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In the following we will therefore focus on the overarching concern from the perspective of Danish banks and mortgage banks; the proposed risk weights for real estate exposures in conjunction with the possibility to introduce a floor for risk weighted assets under the IRB approach based on the new standardised approach.

In Denmark, as in several other European countries, real estate financing by IRB banks and specialised mortgage banks plays an important role for the economy. The standardised approach is not reflective of the low loss and impairment rates on mortgages in Denmark. As a result, the possible introduction of a permanent capital floor based on a "one-size-fits-all"- standardised approach would disconnect the link between the risk of these loans and the required capital levels in our market and thus distorting the pricing of mortgage loans. This could have negative consequences for the overall economy and be a setback for the possibility of regaining sustainable growth. 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, we believe, would not be conducive for financial stability.

**Calibration of risk weights in the real estate exposure class**

Real estate markets function very differently in countries and differences in social security systems, the legal framework for mortgages, foreclosure processes and cultural behavior can have a profound effect on loss rates. For instance, creditor protection is extremely strong in Denmark and foreclosure processes are efficient which is reflected in very low losses on mortgage lending. It is important to have a risk weight system that acknowledges such differences in losses. There is nothing to prevent different risk weightings across jurisdictions based on actual losses and structural differences between countries (systems of forced sale, pension assets, etc.) Actual losses reflect the risks on the collateral and the client, as well as country specific elements. Indeed, that would increase the comparability of risks across countries/areas/systems.

Furthermore, compared to other exposure classes, the risk weights for loans secured by real estate property may reflect local conditions as the risk weights are dependent on the location of the property for which the loan is mortgaged and not the risk weighting of property in the jurisdictions where the credit institution is located. Therefore there is no unlevel playing field issue whereby local authorities by accepting undue low risk weights put local credit institutions in a favorable position compared to foreign credit institutions (no "race to the bottom" risk). It is therefore sound – within bounds - to allow some discretion to local competent authorities to determine the risk weight of loans secured by real estate property located in their jurisdiction and , if relevant – also within regions of their jurisdictions.

In Denmark the loss and impairments data are in the low end of the distribution in both a European and a global context. The implied risk weights based on Danish loss experience are in absolute and relative terms very low compared to the revised standardised approach. Should a capital floor be introduced based on this version of the standardised approach, the distortionary effects on Danish banks and mortgage bank will be significant.

On this background we strongly urge the Basel Committee to consider allowing for local calibration in order to lower risk weight by national authorities if local market conditions and loss rates can be documented to support such lower risk weights.

If local calibration is not deemed feasible, the risk weights for real estate exposures should be significantly re-calibrated to better reflect the risk of such exposures in jurisdictions with structural factors underpinning sustainable low loss rates. Under this approach, on which principle the present proposal in the consultative document is actually based, competent authorities should increase risk weights if the risk weights are not supported by local market conditions.

Evidence on loss experiences of European IRB banks transposed into risk weights by using the formula given in the Basel III suggests that an appropriately conservative starting point for risk weight in low loss jurisdiction could be below 20 % for loans beneath the 80 % LTV bracket. The annex provides more detailed information supporting this suggestion.

### **Tranching or splitting loans across different LTV buckets**

The proposal suggests using a top LTV bucket approach, ie placing the entire exposure in the top category with the highest risk weight. From a risk perspective, when LTV's are used as a proxy for LGD's, the so-called continuous LTV should be used under which an exposure is split across different LTV buckets.

Furthermore, the present proposal creates an incentive to split a loan into several loans for example from 0-40 % LTV, from 40-60 % LTV and so on. From a the credit institution's perspective it will reduce the risk adjusted exposures but from a customer's perspective it will be more expensive with the registration of for example three loans instead of one loan.

### **LTV calculation**

According to the proposal, banks should be using the original property value measured at the time of loan origination. In our opinion, LTVs should be calculated on the basis of the current debt outstanding as well as the current property value. The present proposal creates an incentive to change credit institution as customers would be able to obtain a lower risk weighting as prices increase.

### **Repayment and recovery dependent on the cash flow generated by the property**

The proposed risk weights for residential property which is materially dependent on the cash flows generated by the property are in our opinion disproportionately high. Therefore, to take due account to country specific differences the national supervisory authorities should decide if there is a material dependency between the repayment of the loan and the cash flow generated by the property requiring a higher risk weight. Otherwise for well-developed and long-established housing property markets with very low losses there should be an option for the institutions to exclude the rental property from the treatment as materially dependent on cash flow generated by the property. Evidence of such a market could be subject to the fulfilment of strict conditions on loss rates. This treatment would be in line with the EU-regulation on capital requirements on rental property.

### **Covered bonds**

Covered bonds play a very significant role in the European financial system. Notwithstanding that covered bonds are not included as a special risk category in the proposed framework, it is very important that covered bonds issued by a credit institution in jurisdictions with specific covered bond legislation that fulfills certain strictly defined criteria may have a preferential risk weight treatment.

Yours faithfully



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## **ANNEX – Risk weights for loans secured by residential real estate property**

This annex refers to a study by the European Banking Authority of 43 EU IRB banks across 14 different EU jurisdictions. The study showed an average median risk weight for loans beneath 85 % LTV of well below 15 % for all years 2001 to 2012. The sample included banks in both high loss and low loss jurisdictions in that period.

These risk weight are based on very substantial data underlying PD and LGD estimation and calculated by using the formula given in the Basel III standard.

This indicates that the proposed risk weight of 35 % for loans below the 80 % LTV bracket does not reflect appropriate risk weight in jurisdictions where structural factors result in sustainably low credit losses. Rather, the data suggests that an appropriate conservative starting point for risk weight in low loss jurisdiction would be around 20 % for loans beneath the 80 % LTV bracket. Using this as a reference, national authorities should increase the risk weights when local conditions do not support sustainable low loss rates.

### **Can IRB risk weights be used as a credible starting point for calibration of SA RRE risk weights?**

- Under IRB estimated PDs and LGDs are transformed by the formula - provided by the Basel Committee - to RWs for loans and thus a measure of capital requirements to cover unexpected losses
- PD and LGD estimates for loans secured by residential property are based on large amounts of data, including loss data, covering many years.

### **Average IRB RWs for RRE in EU Member States in 2012**

An EBA study show the following average median risk weights across EU countries for RRE loans in 2012 based on a sample of 43 IRB bank:

Country	BE	CZ	DE	DK	ES	FI	FR	IE	IT	LU	NL	NO	PL	PT	SE	SK	UK	Total
RW (%)	10	26	16	12	17	10	16	45	15	16	10	9	18	22	5	30	11	15

Source: EBA: Fourth report on the consistency of risk weighted assets

Some of the variation between banks and between countries may not be explained by the soundness of the loan portfolios alone – but by different implementation of the IRB Approach across institutions and jurisdictions.

However, the overall average across countries in EU should give a good indication of the average level of RW across both low risk and high risk countries based on robust data and the Basel Committee formula.

## Variation in EU median RRE RWs over years and LTV buckets

Chart 30  
Median risk weight by LTV bucket

(percentage)

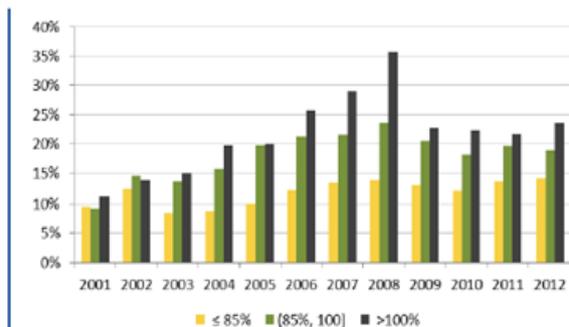
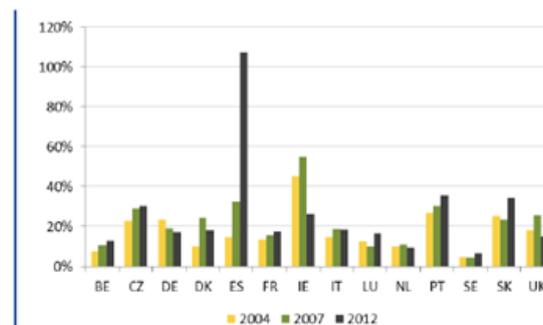


Chart 31  
Median risk weight by country across all LTV categories

(percentage)



Source: ESRB report on residential real estate and financial stability in the EU: December 2015

The tables above show that the average median risk weights across IRB bank across EU countries for RRE loans below 85 % LTV is below 15 % in all years of the 2001-2012 periods.

### Comparison of the BCBS proposed risk weights with EU IRB benchmark risk weights by LTV.

The table below compares the proposed risk weights in the Consultative document in different LTV buckets with the EU country average Risk weights by TV in 2012.

BCBS CD SA proposal				EU bench mark RW by LTV 2012(1)			
Dependent on cash flows generated				Indexed valuation		Value at origination	
No		Yes					
LTVO	RW	LTVO	RW	ILTV	RW	LTVO	RW
0-40 %	25 %	0-60 %	70 %	0-50 %	7 %	0-50 %	7 %
40-60 %	30 %			50-60 %	8 %	50-60 %	8 %
60-80 %	35 %	60-80 %	90 %	60-70 %	10 %	60-70 %	10 %
				70-75 %	11 %	70-75 %	10 %
				75-80 %	13 %	75-80 %	14 %
80-90 %	45 %	>80 %	120 %	80-85 %	15 %	80-85 %	15 %
				85-90 %	17 %	85-90 %	17 %
90-100 %	55 %			90-95 %	20 %	90-95 %	20 %
				95-100%	21 %	95-100%	19%
>100%	100%			100-105 %	24 %	100-105 %	17 %

(1) Source. EBA: Fourths report on the consistency of risk weighted assets. ESRB report on residential real estate and financial stability in the EU. December 2015

The table shows that the proposed risk weights by LTV buckets are substantially above risk weights generated by the IRB formula and PD and LGD estimates on average for European IRB banks across member states involving both high risk and low risk jurisdictions.