MINISTRY OF BUSINESS AND GROWTH
DENMARK

Basel Committee
Centralbahnplatz 2
4051 Basel
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MINISTER FOR BUSINESS AND GROWTH

Dear chairman Stefan Ingves

The Danish government appreciates the opportunity to comment on the consultative document "Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches".

First of all, I would like to thank you for our constructive meeting on 22th April where I had the opportunity to express the Danish views on the proposal, including our strong concerns for the Danish mortgage credit sector.

Overall, we generally support the Basel Committee's objective of reducing the complexity of the regulatory framework, improving comparability and addressing excessive variability in the capital requirements for credit risk. However, at the same time we have serious concerns regarding elements of the proposal and the implications for the diversity of credit institutions' business models and the functioning of financial markets. We are particularly concerned that the proposal will inadvertently affect market segments with demonstrated low risk.

In particular, we have strong concerns regarding a significant negative effect on the Danish mortgage credit institutions due to their low risk business model, where the average loan impairment charge has been 0.2 per cent over the past 30 years while the corresponding average for commercial and savings banks has been 1.0 per cent. The proposal will, in its current form, most likely increase capital requirement substantially and generally decrease risk sensitivity with direct consequences for risk management. Furthermore, decreasing the risk sensitivity gives the credit institutions incentives to shift their portfolios towards higher risk assets.

Generally, it is in our view very important that non-risk weighted capital requirements only serve as a back stop to risk-based requirements. Risk-based capital requirements – when properly regulated and supervised – provide appropriate incentives for credit institutions and they promote efficient capital allocation to the benefit of our economies.

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I understand that it is not the intention to increase the overall capital requirements. While a simple recalibration might achieve this aim overall, we are concerned that a simple recalibration will not duly recognise the inherent low risk nature of some business markets and business models.
On this background we strongly urge the Committee to thoroughly analyse the consequences of the proposal, including the quantitative impact study (QIS) and the consultation responses.

The views of the Danish government are described in more detail in the attached annex. Below our main comments are summarised.

Generally, the Danish government neither support the proposed revised Basel floor nor the input floors on the parameters in the internal models.

In the consultative document the Committee briefly mentions its plans to replace the current Basel I floor with a permanent output floor based on the revised standardised approach. We would like to stress that the use of an output floor limits the risk sensitivity of the framework, hence creates incentives for banks to shift their portfolios towards higher risk. Furthermore, we see an imminent risk that the Committee's aim not to significantly increase overall capital requirements can be severely undermined by a permanent output floor based on the standardised approach unless the consequences are thoroughly analysed.

The Committee mentions that the interaction between input floors, output floor and the leverage ratio will be considered. This is in our view very important as we believe that the introduction of a leverage ratio by and large addresses the same concerns as an output floor (risk weights become too low and do not reflect true risks).

Moreover, when it comes to input floors the Committee proposes to set exposure-level floors on IRB-model parameters. We generally agree with the Committee's line of reasoning, including in particular that national specificities and banks' incentives should be taken into account. However, we fail to see how this is reflected in the concrete proposal.

Specifically, we anticipate that the QIS will show a huge effect from the loss given default LGD floors on the Danish mortgage system. It is important to stress that we do not see justification for such an effect given the actual loss history of these institutions and the specific features of the Danish market. Following this, we find a floor on exposure level for exposures secured by real estate problematic, as it targets demonstrably low risk exposures. Please see the attached annex for a more thorough description of the Danish mortgage system.

Against this background, we strongly urge the Committee to take another approach to the calibration of the parameter floors and to abandon the use of floors on individual exposure level, especially for exposures secured by real estate.

Lastly, the Committee proposes to abandon the use of banks' own estimates of model parameters for Specialised Lending (SL). It is our understanding that this change is based on the Committee's concerns about the modellability of such exposures, e.g. due to lack of data or correlation between creditworthiness of the borrower and the value of the asset being financed. Overall, we are concerned that this proposal will lead to an unwarranted increase in capital requirements, a loss of risk sensitivity and as a consequence incentive for banks to shift their portfolios towards higher risk. This increase in capital requirements will most likely have a negative effect on social housing in terms of higher housing costs.

We therefore strongly urge the Committee to take a more granular approach which allows the use of the advanced IRB-model for the subcategory "Income Producing Real Estate" if the institutions can document the availability of sufficient historical data and fulfil all requirements for IRB modelling.

As always, we stand ready to answer any questions you may have in relation to these comments.

Yours sincerely,

Troels Lund Poulsen