Realkreditrådet
ASSOCIATION OF
DANISH MORTGAGE BANKS

To: The European Banking Authority
by email: DP-2012-03@eba.europa.eu

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Comments on EBA's discussion paper regarding draft RTS on Prudent Valuation

The association of Danish Mortgage Banks is pleased to get the opportunity to comment at an early stage on the technical implementation of article 31 of the CRR. We generally consider that the intention of prudent valuation is warranted given the lessons learned from the financial crisis. In this respect, the Danish mortgage model fits in well as the nature of valuation is based on prudence.

Further, we view the underlying philosophy of article 31 as being consistent with article 30 that also relates to how fair valued instruments influence the calculation of an institution's own funds. Specifically, we were happy with the amendment of article 30 (b) stating that the calculation of an institution's own funds depends on the business model design ensuring that e.g. the Danish mortgage model that performed well both before, during and after the financial crisis, is not hit unintentionally.

General comment

Article 31 states that all fair valued positions are subject to prudent valuation, trading book positions or not. As a first general comment, we find that the inclusion of non-trading book positions in the scope of article 31 increases the risk of an un-level playing field following the new regulation as different accounting standards across jurisdictions can lead to different outcomes. In particular, institutions applying the fair value option under IAS 39 could be negatively affected from a regulatory capital point of view.

Prudent valuation in relation to Danish mortgage loans

Danish mortgage banks are specialized banks that fund mortgage loans exclusively by issuance of covered bonds. The mortgage banks are legally subject to a so-called balance principle that ensures that the asset side (the non-traded loans) mirrors the liability side (the issued bonds) of the mortgage banks' balance sheets. Accordingly, the loan type, repayment profile, term and currency determine which bonds the mortgage bank will sell to fund the loans. This pass-through system ensures that the mortgage banks only serve as intermediaries between borrowers and bond investors and that mortgage banks are only subject to credit risk; all other risks including market risk are thus outsourced to the borrowers and bond investors.

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To avoid accounting inconsistencies between the fair-valued bonds and the non-traded loans, the Danish mortgage institutions use the fair value option of IAS 39. Thus, for accounting purposes, mortgage loans are designated at fair value and not at amortized cost price that applies in other mortgage models across the world. Accordingly, Danish mortgage loans will be subject to the new standards on prudent valuation.

Technically, the price of the loans is derived mechanically from the market prices of the bonds. This perfect hedge ensures that any changes in the price of the bonds will have a corresponding effect on the value of the loans. Thus, any additional value adjustments will leave Danish mortgage banks' own funds unaffected. In addition, as the valuation of the bonds is prudent, the structural characteristics of the Danish mortgage model thus implies that the current system is compliant with the underlying philosophy of prudent valuation.

As mentioned above, we assume that article 31 of CRR is consistent with article 30. Under the current wording of article 30 (b), the own funds of an institution is unaffected by changes in the own credit standing of the institution, when gains or losses on liabilities are exactly offset by a corresponding change in the fair value of another financial instrument measured at fair value. In the same manner, we consider that prudential valuation does not alter the own funds of Danish mortgage banks as the value and the additional value adjustments on the asset and liabilities exactly offset each other.

Yours sincerely

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Annex

Danish mortgage banks fund mortgage loans exclusively by issuing listed bonds. Accordingly, there is a one-to-one relationship between the granted loans on the mortgage banks' asset side and the issued bonds on the liability side of the mortgage banks' balance sheets. This implies that mortgage banks only fund loans by selling bonds with matching characteristics and that bonds can only be redeemed when a borrower decides to redeem a loan. This is done by either the borrower or the mortgage bank buying the bonds in the market. This close relationship ensures that changes in market risk of loans (assets) and bonds (liabilities) are totally matched keeping the capital level of the mortgage bank unaffected. This construction eliminates all market risk for the mortgage banks. Therefore the Danish mortgage banks are only subject to credit risk.

For accounting purposes, recognizing both the loans and the bonds at fair value through profit or loss in the financial statements, eliminates the inconsistency in the timing of the recognition of gains and losses that would otherwise result from measuring them both at amortized cost and recognizing a gain or loss each time a bond is repurchased. Since the adoption of IFRS in 2005, Danish mortgage banks have therefore used the fair value option according to IAS 39 9(b)(i) and IAS 39 AG4E(d)(ii) to value both the mortgage loans as well as the issued covered bonds. This treatment ensures that no accounting mismatches were created by IAS 39. The reason is that the change in value of the loans will be offset by the opposite change in the bond price. The IAS 39 and the possibility of fair valuing both the asset and the liability ensures that there is no accounting mismatch. Any change in the market risk of the mortgage loans will therefore have a corresponding effect on the market price of the bond.

The Danish mortgage system

Danish mortgage banks are specialized banks, which only grant loans against mortgages on real property by issuing covered bonds. Loans are granted at loan-to-value (LTV) ratios of up to 80% for private residential loans and typically up to 60% for other purposes, including commercial purposes. Mortgage banks have only one source of funding: bond sales. Thus, a mortgage bank does not operate in the same way as a commercial bank, which may take deposits or raise money market funding.

As the mortgage system is based on a principle of matching, all loans are matched with certain bonds (see chart 1). The loan type, repayment profile, term and currency thus determine which bonds the mortgage bank will sell. This ensures transparent loan costs, market-based prices, and unique prepayment options for borrowers. The match funding principle applies to all loans. In connection with adjustable-rate mortgages, the maturity of the underlying bonds is generally shorter than the loan terms. Here the match funding principle applies to the individual interest periods between refinancings. When the loan is refinanced, the underlying bonds are replaced. Further, the adjustable-rate mortgages are constructed in a way that ensures that the borrower (and not the mortgage bank) has the full refinancing risk – any change in interest rates is fully transferred to borrower.

All loans are funded on a current basis (tap issuance). That is, the mortgage bank issues the required bonds at the same time the loan is disbursed to the borrower. The prevailing market price consequently determines the loan rate faced by the borrower. In addition to the interest payment on the bonds, total costs also include a fee to the mortgage bank covering daily operating expenses and loan losses. Borrowers know which bonds fund their loans. As the bonds are listed on a stock exchange, borrowers can easily monitor market trends and thus the price they are paying. Borrowers may always prepay their loan by buying the underlying bonds in the market – this option is frequently used when market prices are in the favor of the borrowers.

Mortgage loans remain on the balance sheet of the issuing mortgage bank until maturity. The mortgage bank thus carries the credit risk on the loans until they mature. The mortgage bank thus have strong incentives to closely monitor the credit quality of its portfolio. In case of a loan defaulting, the mortgage bank will claim the underlying collateral (the real property). Danish law ensures a fast foreclosure process implying that the mortgage bank can easily access the collateral. Further, the borrower is subject to so-called full recourse liability which means that the mortgage bank can maintain a claim on the borrower, in case the realization of the collateral results in a loss for the mortgage bank.

The Danish mortgage system is based on a one-to-one relationship between Danish mortgage banks' lending and issued mortgage bonds. The covered bond market plays a very important role in the Danish economy due to its size. By end of July 2012, outstanding covered bonds amounted to EUR 367 corresponding to approx. 150% of Danish GDP. In comparison, outstanding government bonds amounted to EUR 105bn. The Danish covered bond market is Europe's third largest with the German Pfandbrief market as the largest and Spain as the second largest.

Chart 1 – stylized illustration of the danish mortgage system