To
Nordic Credit Rating

Finance Denmark's comments to Nordic Credit Rating's Request for Comment on proposed covered bond rating methodology

FINANCE
DENMARK

May 29, 2019
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Contact Lars Ravn Knudsen

Finance Denmark is a business association for banks, mortgage institutions, asset management, securities trading and investment funds in Denmark. We appreciate the consultation and the possibility to give feedback to Nordic Credit Rating's proposed covered bond rating methodology.

The covered bond ratings universe can only benefit from the introduction of additional views and perspectives. There is a structural weakness built-in in most current frameworks since they are not based on actual risk measurement but more reflect a perception-based approach. It is not uncommon, that a clear definition of stress is lacking. In order to develop risk measurement and risk calibration it is therefore important that rating criteria are founded on a reliable, valid and transparent criteria. In this respect, the views of Nordic Credit Rating may be as important as the views of the leading players in the ratings industry.

In order to facilitate the thought process for the calibration of stress levels and their associated consequences our feedback also includes a small example database comprising covered bond relevant data, which is readily available on the internet for most developed markets. To introduce a framework, which is based on empirical evidence would add value compared to existing rating methodologies for covered bonds.

Conceptually we see Nordic Credit Rating's criteria as in line with other rating agencies and we support the linking of covered bond ratings to the issuer rating. Based on the comparative importance of covered bond funding in all Nordic markets criteria should clearly reference its link to market standards and practices as well as how these markets have been functioning for many decades. Covered bonds are systemically more important in the Nordic market than in most markets globally.

- More precision on which indicative credit assessment (issuer vs covered bond) Nordic Credit Rating is referring to would be helpful. The paragraph 14 refers to the issuer's indicative credit assessment in the context of the issuer rating while paragraph 37-39 refer to the indicative credit assessment of the covered bonds. This needs clarification.

- It would be helpful if Nordic Credit Rating were to state more explicitly, why Nordic Credit Rating does not give great value to cash flow analysis for highly rated issuers. However, there is on-going surveillance of the pool based on publicly available information. We believe it is relevant to not over-analyse cases where default risk is very minute, and in addition the cover pool composition will change over time, in particular in cases where there is material deterioration of asset quality.

- It is not clear from the draft what buffer is consistent with a two notch senior unsecured rating uplift in the process of establishing the covered bond rating? A precise cross-reference to the Financial Institution criteria would be helpful. You may consider a hyper-link in the electronic document. Given that ratings criteria are increasingly complex it is valuable to facilitate the correct reading.

- It would be helpful to state the impact on the "covered bond hierarchy" if a single-point-of-entry resolution strategy is in place, for both match-funded and non-match funded covered bond programs.

- More detail on the qualitative analysis undertaken by Nordic Credit Rating on how and the extent to which ratings of counterparties can impact covered bond ratings would be helpful. It is preferable that all potential concerns are addressed upfront, rather than to have additional concerns added later on. Our experience with other rating agencies has been that there is a tendency to keep adding factors to the rating process. This increases operational risks and create event risks as well as additional complexity and cost. It is important that any covered bond framework is thought-through and allows a cost-efficient internal management process.

While most credit rating scales are well defined, and refers to a specific level of default likelihood, this is not equally clear when it comes to the conditions that different levels of stress represent. Conceptually an objective scale of stress is missing, that could play the role of the Celsius scale for temperature or the Richter scale for earthquakes. At present, credit ratings for covered bonds refer to stress assumptions that if they were put in a systematic economic model, would require the complete destruction of society. Such assumptions reduce the relevance of the covered bond ratings and create difficulties in the scaling of relative risk over time and under varying economic conditions.

Today most existing rating criteria assume quite severe losses at the AAA rating level and if the issuer rating is lowered the required overcollateralisation and thus the assumed losses are expected to worsen considerably. While the cyclical nature of bank defaults is well documented (Törnqvist, & Bang 2017, www.ssrn.com) it is also clear that losses for secured lending are but a fraction of the losses for unsecured lending. The worst loss ever for banking in Denmark is about 12% (see table 1), while the worst loss experience for secured lending is only 0.65%. This is a structural difference, which needs to be recognized in the rating of covered bonds.

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Table 1. Impairment losses for selected categories of financial institutions

Country	Period	Average annual impairments to net loans (%)	Median annual impairments to net loans (%)	Maximum annual impairments to net loans (%)	In year
United States					
National banks	1888-1970	0.86	0.74	6.44	1933
FDIC insured banks	1934-2014	0.62	0.42	3.56	2010
Denmark					
Commercial banks	1921-2014	1.20	0.76	11.93	1922
Savings banks	1928-1989	0.40	0.01	3.16	1982
Mortgage banks	1915-2014	0.11	0.05	0.78	1990
Finland					
Commercial banks	1934-2013	0.64	0.42	6.64	1993
Savings banks	1947-2013	0.47	0.31	10.44	1992
Cooperative banks	1946-2013	0.34	0.19	2.91	1994
Mortgage banks	1946-1991	0.06	0.05	0.17	1948
Postal Savings bank	1917-1988	0.43	0.28	4.35	1948
Norway					
Commercial banks	1900-2001	1.59	1.00	5.84	1991
Savings banks	1885-2001	0.50	0.30	2.47	1989
Sweden					
Commercial banks	1874-2014	1.10	0.84	7.51	1992
Savings banks	1893-2014	0.65	0.42	8.44	1992
Cooperative banks	1969-1992	1.43	0.77	10.61	1991
Mortgage banks	1991-2014	0.14	0.01	0.65	1993

Source: National statistical reports complied by Danske Bank.

Data is today available from most statistical sources covering extended periods. Typically, Nordic markets have well-defined statistical reports covering relevant aspects of society for the period 1850 to date available on the Internet. Data concerning the trading of real estate, the registration of title deeds, the registration of pledges, forced auctions, payment orders and bankruptcies are generally well defined and available giving a good picture of the development of property markets under varying economic and financial conditions. This information provides important perspectives to the likelihood of loss in the covered bond market. It would be unfortunate if stress were calibrated in such a way for covered bonds that society beyond the covered bond pool has ceased to exist.

One key aspect in the analysis of covered bond markets and their ability to stay functioning also under severe adverse conditions is the link between a domestic investor base, employment, the accrual of mandatory pension savings and the need to invest in a domestic currency in order to match long-term liabilities in the same currency. This logic is referenced in the draft criteria and should be modelled into any stressed market assumptions. As margins on covered bonds, widen in an adverse economic scenario the resulting yields will become increasingly interesting for domestic investors, with a requirement to manage long-term liabilities in the same currency.

Kind regards

Lars Ravn Knudsen
lrk@fida.dk
(+45) 33 70 12 69

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Appendix I - List of liquidated mortgage banks in the Nordic countries

In Sweden, there are two historic instances where mortgage-based institutions have been liquidated (1879 and 1993) as well as four implicit defaults, where an institution could have failed had it not been reconstructed or merged.
Looking at the other Nordic countries, which all have large structural economic and financial similarities with Sweden there are also very few examples. In Denmark one institution has been liquidated (1870) and one reconstructed (1931). In Finland, there are four instances of implicit defaults, but no examples of liquidations. Finally, in Norway there have not been any examples of a mortgage bank liquidation, because the domestic bond market has been of limited importance historically and not until after the millennium, have there been mortgage banks of any systemic importance. Hence, there is little historic precedence to refer to in terms of most likely behaviour.

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AB Göteborgs Handelskompani	1879	Sweden
Kreditforeningen for Kjøbstadsgrundejere i Nørrejylland	1860	Denmark
Näringslivskredit AB	1996	Sweden

Source:

Bank Defaults – Not as Rare as Expected and Quite Possible to Document, Törnqvist, Bang 2017 www.ssrn.com

It may be argued that den Brettonske Hypotheksforening should be considered as a default in Denmark, but firstly it was not a permanent institution and secondly it was not incorporated as a Kreditforening under the Mortgage Credit Act of 1850, as such it is not evident that it should be considered in the context of failed mortgage banks. (Glud, Torben, Kreditforenings Institutionen I Danmark, 1951 page 51.)