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The Ministry of Finance of the Czech Republic response to the Commission Services Staff Working Document on further possible changes to the Capital Requirements Directive dated 26 February 2010

General comments

The Ministry of Finance of the Czech Republic highly appreciates the possibility to comment on possible changes to the Capital Requirements Directive (CRD) and welcomes that a package of reforms to CRD (CRD IV) is closely aligned with the changes to international capital and liquidity standards proposed by the Basel Committee for Banking Supervision (BCBS) in December 2009.

The following comments cannot be considered at this stage as the final official policy position due to the general nature of the CRD IV proposal and the current lack of impact assessment.

We believe that any proposals will be carefully considered by the European Commission (Commission) and final solutions will be made after considering the impacts on the banking sector.

Answers to individual areas

Liquidity standards

To questions 1 to 6

Sound liquidity in banking sector is a key element for safe and functioning financial system. Therefore, the Czech Republic considers the aim to introduce internationally respected liquidity standard in banking and other parts of the financial system as highly desirable. We suppose that the new regulation in liquidity risk management has relevant capacity to increase the soundness of the global financial system.

In Annex I which outlines also the “high quality liquid assets” for the Liquidity Coverage Ratio (LCR) we are missing the central governments` and central banks` debt instruments denominated in the European Union (EU) currencies. We suppose this is an issue of significant importance for non-euro EU countries. Regarding the calibration of “liquidity factor” which shall be used in calculation of the LCR and the Net Stable Funding Ratio (NSFR), we consider it fundamental that the said calculation should be based on a detailed impact assessment. We believe that as for calibration of bank bonds which belong to high liquid buffers the supervisor of the bank which issues these bonds should be involved in decision making.

We have tentatively consulted some members of industry in the Czech Republic with respect to the two new standards regarding better liquidity risk management – the LCR and the NSFR. They are of the view that bank bonds should be included in the LCR buffer and assets in this buffer should have the quality to be eligible for a given central bank. They deem the NSFR as too strict, since the funding provided by financial enterprises is not included. However, they do not expect any change in pricing of banking products. They consider the calibration of the funding availability factor as a demanding task for the competent authority with an uncertain result.

To questions 7 to 12

We fully agree with the Commission that there is a need to reflect national specificities of certain retail deposits for the LCR and the NSFR. We believe that elementary parameters of that instruments should be set at the EU level by the European banking Authority (EBA). However, the established objective to reflect national specificities could be ensured, in our opinion, only by allowing some evaluation for competent authorities at the national level.

As regards the scope of application we believe that the new regulation could keep the same logic as applied on capital requirements – to meet the requirements on an individual and also on consolidated basis. Liquidity is the very crucial element of sound banking system. Therefore, we consider absolutely necessary that the potential application of the waiver should be decided on by the competent authority at the individual level.

Regarding the possible application of the liquidity standards on investment firms, we are of the view that those of the investment firms which are limited in initial capital and in their activities should not be subject to this requirements. However, the 730K investment firms should meet these requirements in some restricted form.

The treatment of intra-group transactions and commitments raised by the Commission is a very relevant issue. We share the Commission´s concerns regarding non-symmetrical treatment and believe that it should be solved within the CRD IV proposal. After consideration and on the basis of the consultation with some members of the industry performing in the Czech Republic we would express some preliminary sympathy to the first symmetrical treatment which mirrors the absence of inflow for one group member as the absence of liquidity outflow for another.

To questions 13 to 15:

We assume that the shift of the responsibilities for the supervision of branches` liquidity could be considered provided that harmonized standards and adequate safeguards (LCR, NSFR) were introduced. We also expect that minimum standards for the collaboration between home and host supervisors would be spelled out in the Directive. The host supervisor should have access to all relevant information also in case of non-significant branches. Moreover, shifting the onus of liquidity supervision from the solo level to the group level would have to be conditioned for example by the fact that a given group manages the liquidity risk at the group level. The shift of the responsibility for the supervision of branches` liquidity should enable the execution of power and enforceability by the national supervisory authority responsible for financial stability. As regards the proposed tools for liquidity risk monitoring we welcome the new regulation. We would like to add that some banks performing in the Czech Republic have already implemented them into their systems.

Definition of capital

To questions 16 to 24

The Czech Republic supports the Commission´s proposals as regards the simplification of capital structure and enhancement of its quality. Nevertheless, we would like to stress that the results of the quantitative impact studies are indispensable for the further work on this issue and deeper examination of the Commission´s proposals.

As regards the changes relating to the capital structure, we think that the proposed elimination of Upper Tier 2 from the capital structure could be an acceptable measure since there are no limits applicable to this part of capital. We support the elimination of Tier 3 capital as well.

We have discussed the proposed criteria for Core Tier 1, non-Core Tier 1 and Tier 2 and their robustness with some capital market participants. They have pointed out that the CRD IV proposal not to include minority interests in Core T1 would cause unsystematic change of capital adequacy. They have mentioned that Core T1 would decrease but, on the other hand all the risk-weighted assets generated by this type of capital would remain unchanged. There would be no use of capital raised from minority shareholders on the consolidated basis. They believe that the approach should be balanced on both sides, i.e. if the capital were decreased, the risk-weighted assets generated by this particular part of capital should be decreased as well. If the issue targeted by the regulators were uneven distribution of capital and risks over the entities within a consolidated group, the solution could be based on proportional inclusion of such a capital. In other words, at least the capital supporting risks connected with an entity shall be included in consolidation, i.e. in volume of minimum capital requirement of an entity.

As regards the effective loss absorbency of non-Core Tier 1 capital and triggers, we would like to wait for the results of the quantitative impact studies currently carried out by various institutions. These results would also help us to better understand e.g. the purpose of the contingent capital and consider its impact.

Finally, as regards large exposures, we are not persuaded of the appropriateness of further changes of the current regime. In case that the large exposures limit was based on Tier 1, it would be necessary to determine the appropriate calibration of the current limit of 25% of own funds so that any undesirable impacts on exposures with long-term maturities held by credit institutions were eliminated. But, it is questionable whether this re-calibration would reach the desirable objectives.

Nevertheless, we consider it important to analyse further the impact of proposals in the area of capital on credit institutions´ exposures, on the keeping and application of the stipulated limit. It is necessary to ensure that credit institutions were not compelled to limit their exposures while they incur disproportionate costs on the basis of an amended regulatory approach in the area of capital.

Leverage ratio

To questions 25 to 30

We are of the view that the introduction of a leverage ratio as a complementary tool to the minimum capital requirements could contribute to the reduction of the scope for speculative investments and an excessive growth of balance sheets of financial institutions. We agree with the definition of capital as Tier 1 and Core Tier 1.

We consulted this issue with a part of banking sector. According to its opinion it would be appropriate to consider for the purposes of impact assessment studies only the capital Core Tier 1. The proposed approaches to exposures measurement of derivatives is considered to be appropriate. The indicator of the leverage ratio could be mandatory only for systemically important institutions and universal banks. Regarding the other non-systemically important institutions with a limited range of services the responsibility of the competent authority could be to determine whether the application of the leverage ratio will be mandatory or whether this indicator will be only monitored and assessed and an appropriate action would be considered in case of an emergency situation. At this time it is difficult to estimate the impacts on the efficiency and liquidity of financial markets because they will depend on the calibration of the leverage ratio. In this context it is necessary to test entire industry which should be represented by different types of financial institutions.

Counterparty credit risk

To questions 31 to 37:

The Czech Republic supports the aim to improve the methods for measuring counterparty credit risk and consequently reach the sufficient capital coverage. The issue of central counterparties or more precisely their use for OTC derivatives clearing presents is quite sensitive. The proposed enhancement of standards for central counterparties is desirable. We are of the view that by complying with them a zero capital risk weight could be applied. However, we do not support the aim to use central counterparties to clear all of the derivatives. In such a case the systemic risk of these institutions would be much higher and this fact should be reflected in risk weights of exposures that banks would hold.

Countercyclical measures

To questions 38 and 39

The Czech Republic is supportive of the efforts by the Commission to avoid pro-cyclicality. We are encouraged that the Commission intends to undertake a comparative analysis of the Expected Cash Flow (ECF) method that was put forward by the International Accounting Standards Board (IASB), the Incurred Loss Model under current IAS 39 and the IRB Method proposed by the Commission.

As for the IRB method, we support the view that it is a regulatory measure that is without direct connection to accountancy. However, we find questionable the discrepancy between this method and the work of IASB.

Considering the ECF model, its main disadvantage lies, in our opinion, in relatively difficult implementation regarding the possibility to set higher expected loss (which spreads over the life of the loan) at the moment of providing credit and to lower them after the first reassessment (which is recognized in balance sheet as an immediate write-off) – thus the model can be subjectively manipulated.

However, we are aware of the fact that the comment period of the IASB Exposure draft has not expired yet and there is no final version of the standard. Therefore, it cannot be ruled out that some changes in the exposure draft may occur and we may modify our current view on the output of IASB work.

To questions 40 to 43:

The introduction of capital buffers could be one of the possible tools to increase the resilience of the financial sector and reduce pro-cyclicality of the existing regulation. The evaluation of effectiveness of the introduction of capital buffers will be possible on the basis of detailed analysis and impact assessment studies. In the case of capital conservation buffer it is necessary to determine the size of conservation range. In this context, it is desirable to specify how and by whom will the size of conservation range be determined. We consider the introduction of counter capital buffer tied to macroeconomic development relatively difficult to adjust. It is necessary to ensure a flexible approach with regard to the diversity of institutions and member states' economies. This idea is shared by a part of the industry that has been consulted regarding the consultation. We believe that a discussion of the results of impact studies should also include discussion regarding the specification of the time frame that will indicate the obligation to build up the conservation buffer after implementation of the relevant provisions in the CRD. We would not consider it appropriate to decide on the date of introduction of that obligation during the legislative process.

In our opinion, the capital distribution constraints should be imposed on dividend payments and bonus payments to staff.

Capital distribution constraints should be determined as of the year succeeding the year in which capital level of the credit institution falls within the conservation range. The time limit for reaching the target should be determined by the supervisor and respect an economic situation of the particular institution in broader context.

An international authority should be entrusted with monitoring of the develepment of countries and regions in particular. This authority should also propose non-binding recommendations on how to choose macroeconomic variables and set their threshold for building up a capital buffer. In the European Union this role could be played by the European Systemic Risk Board.

Systemically important financial institutions

To questions 46 and 47

We are aware of the fact that any labelling of the institution as "SIFI" may induce the risk of moral hazard. Nevertheless, even if no pre-defined list of systemically important institutions is defined or referred to, it is not difficult to assess the systemic importance of the institution on a basis of available information on its activities and results including its interconnectedness. We support systemic importance to be defined at the level responsible for financial stability. We consider that the systemic importance shall be defined at the level responsible for the financial stability, i.e. the national level.

We agree with the Commission that size is a key feature of systemic importance, but not the only one. We believe that the reasons for considering the branch of a credit institution to be significant (laid down in Article 42a of the CRD directive) might be helpful to define basic factors of the systemic importance of the institution. Within the possible criteria we have identified several features as follows:

(a) size according to market share of a credit institution in terms of deposit in the Member state;
(b) significance of a credit institution in terms of number of clients within banking or financial system in the Member state;
(c) degree of damage to the market liquidity and clearing systems in the Member state caused by distress or failure of a credit institution;
(d) interconnectedness;
(e) substituability;
(f) complexity;
(g) funding structure.

This basic criteria may be used to define the systemic importance in combination with the assessment of other relevant factors comprising e.g. the structure of an institution or its specific risk profile. It is also essential to take into account the structure of the relevant financial market or the influence of the current economic cycle. Therefore, it is clear that the analysis of the SIFIs definition will be time-varying. Nevertheless, in our opinion, relative stability of the classification of an institution as SIFI is necessary given possible requirements and costs related to such a status.

We support the discussion on the most flexible and balanced concept of criteria so that the definition of importance of the institution was commensurate with the systemic risk it poses on financial stability. One of the possible approaches consists in categorisation of the institutions based on the criteria mentioned above in connection with categorisation of the risk activities of the institutions. In addition to this, discretionary powers shall be bestowed on the competent authorities to moderate rigidity of borders between the categories to enable the individualisation of the assessment of each institution.

A key question is what kind of measures shall be discussed as for financial institutions and SIFIs in particular. When imposing regulatory measures on SIFIs, discretionary powers of the competent authorities and a sliding scale reflecting degree of systemic risk shall by considered too. Besides emphasis on capital quality enhancement, specific additional capital, liquidity, and other prudential requirements, a special stability fee for financial institutions has been discussed. Due to lack of any deeper analysis we are not able to asses the implications of such a measure. Nonetheless, if such a measure was in consideration, given the targets of such a measure (ensuring that the private sector pays for the negative externalities it generates and elimination of such externalities on real economy, reduction of moral hazard) and regarding preliminary analysis, we would like to propose the amount of the fee to be levied on the institution´s liabilities minus core Tier 1 and deposits covered by guarantee schemes. Differentiation of the fee according to the systemic importance criteria needs to be further studied.

Following the issue of responsibility for financial stability, fees shall be managed and levied by national funds. Deposit guarantee schemes might be engaged, but only on condition of strict separation of means assigned for depositors and those intended for crisis resolution. Using DGS as a structure for financial means concentration might save costs connected with creating new structures. We thus do not support managing these fees on supranational level.

We also find important to discuss the issue of wind-down plans. As for the ex-post measures, setting in place credible recovery and resolution plans for all relevant systemic institutions these should be a shared priority and help to reduce moral hazard. In case of distress of an institution, the competent authority shall be endowed with power to impose adequate measures e.g. to decrease capital requirements or to refrain from other requirements.

We do not find optimal to focus on stand-alone criteria like size or an ex-ante list of risky activities. We consider the latter to be appropriate only as a sanction measure in case of some institution´s deficiency. As for the size, we propose to reinforce the supervision of the competent authority so as to enable the intervention in case of un-transparent structure and governance of the institution. However, restriction on size does not represent any way forward at the global level.

Single rule book in banking

To questions 49 to 52

The Czech Republic generally supports the removal of national discretions and the unification of the rules. Regarding the level of risk weights for commercial real estate, we would support to keep the national discretions though. At present, using the preferential risk weight is not allowed in the Czech Republic because during the preparation of the legislation implementing the CRD any relevant reasons to justify the introduction of more favorable treatment were not found.

Regarding the waiver allowing derogation of risk assessment depending on the value of the borrower's residential real estate, we support the most prudential conditions for its use. We believe that it is necessary to ensure that required overall loss rate included in regulation would be sufficiently prudent, particularly if the current regulation were amended (discretion for the competent authority).

As far as more detailed specification in Annex VI, Part 1, point 48 d), we agree with the replacement of the current vague provisions. Loan to Value (LTV) should be based upon an appropriate assessment. Nevertheless, we consider the proposed value of 80% as the possible basis for further discussion as it is crucial to avoid negative impacts on such an important market segment.

We welcome proposals concerning economic cycle consideration although they need to be further defined and concretized. Setting new indicators appears to be very questionable. Yet, if such indicators were discussed, they might fall within Pillar II. However, we would rather support following current approaches - the mortgage lending value (MLV) in particular.

We support preserving of different treatments of residential and commercial real estates. Higher level of risk weights and stricter conditions for assigning of the preferential risk weight are important for commercial real estate, which might be more often relatively illiquid.

As regards commercial real estate, in the case, that a hard test were adopted as a general condition for the assignment of the preferential risk weight (new point 53a), we would like to note that preserving of the hard test as a condition for applying the waiver in the point 58 would not have to be relevant anymore.