FINANSTILSYNET

M E M O

DANISH FINANCIAL SUPERVISORY AUTHORITY

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Comments on the EU-Commission Services' consultation paper on CRD 4

Finanstilsynet welcomes the opportunity to comment on the consultation regarding further possible changes to the capital requirement directive (CRD 4) as published by the Commission Services on 26 February 2010.

We welcome that the European Commission does not derail the commitment of G-20 leaders to improve the resilience of the global financial system, however we find that it is better that the new framework is introduced in the right way rather than quickly. We find that the European Commission should only take sound peculiarities in EEA countries into account if derogating from global standards.

Finanstilsynet finds the work impressive and supports the overall objective of strengthening bank regulation and embraces the work of the Commission, but also note that some parts need considerable more refinement and our final support to these parts remain pending. Also the results from the QIS exercise will give crucial information. Since a number of new hard requirements are envisaged in the framework, it is important to study the administrative burdens, in particular for smaller and middle-sized banks, and the macroeconomic effects closely.

Finanstilsynet would like to stress that some of the proposed measures unintentionally risk to undermine the Danish mortgage finance system. Finanstilsynet refers to a specific joint memorandum sent to the EU-Commission as well as the Basel Committee on Bank Supervision by Danmarks Nationalbank and Finanstilsynet on 7 April 2010. In addition Finanstilsynet refers to a letter sent from the Danish Minister for Economic and Business Affairs.

This document sets out the Finanstilsynet's response on other issues.

Liquidity standards

This section supplements the joint memorandum sent by Danmarks Nationalbank and Finanstilsynet of 7 April 2010.

Liquidity Coverage Requirement

Finanstilsynet supports the overall objective of the Liquidity Coverage Ratio thus strengthening the resilience markedly in periods of financial stress. We note that the exact calibration of the Liquidity Coverage Ratio after the QIS remains to be seen.

Finanstilsynet welcomes that the Commission Services does not suggest requiring the Liquidity Coverage Ratio to be calculated per currency, and that the adequate currency distribution of buffer assets should be left to the institutions, subject to supervisory review.

Moreover, Finanstilsynet acknowledges that under periods of extreme stress, the liquidity requirements could fail to be fulfilled. In that case the Finanstilsynet finds it prudent to give the supervisor the authority to define a restoration plan to restore compliance over a short timeframe.

Net Stable Funding Requirement

In general, Finanstilsynet welcomes the proposal of stable funding that aims at ensuring a sound funding structure of an institution.

Finanstilsynet finds in that regard that it is important that the liquidity regulation can preserve specific sound business models. In a Danish context a sound business model could for example be small saving banks that rely heavily on deposits. The current proposal as it stands could make it very difficult for these institutions even though many of these institutions are well functioning as to liquidity and are well capitalized.

Finanstilsynet thus proposes that the parameters after the calibration should provide room for a discretional adjustment from the proposed Net Stable Funding requirement.

The calibration of the parameters should take into account the contractual obligations of the bank regarding loan structure, which can make it difficult for the bank to instantly call a large amount of loans. Both the asset and the liability side of balance thus should be taken into account in the calibration.

Too tight liquidity standards entail a risk of drift towards investing in marketable securities, there certainly can be a risk strengthening or creating other markets that may or may not be properly regulated. The exact calibration of the Net Stable Funding Standard after the QIS, including the time horizon of the stable funding, will in the end determine the exact nature of this possible risk.

Completeness of legislative approach
Finanstilsynet believes that it is too early to comment on whether all minimum parameters and categories should be set by the EBA (with possible national standards above these for sub-categories) as this presupposes the exact calibration and division of the parameters.

Scope of application
Finanstilsynet supports the scope of application outlined by the Commission Services. This entails that standards, as a starting point, apply at the level of legal entities, possibility of applying the standards at a consolidated level and waive tem at solo level if the supervisor sees compelling reasons to do so (for example centralized liquidity risk management). The precise conditions for waiving the standard at solo level, remain to be developed, but the proposal it is a step in the right direction.

Investment firms
Finanstilsynet agrees with the Commission Services that the liquidity standard should not apply to all investment firms, but only to those that deal on own account.

Finanstilsynet finds it appropriate to also include financial institutions or 50K investment firms or 125K investment firms in the scope of consolidated liquidity standards of a banking or investment firm group.

Supervisory responsibilities for branch liquidity
Given agreed common liquidity standards, Finanstilsynet has sympathy with a model where the main responsibility for supervision on liquidity is transferred to the home country supervisor in close collaboration with a host country supervisor. The collaboration should, especially for systemic relevant branches, be comprehensive and involve a sharing the responsibility. It should be ensured that host country supervisor has unhindered access to liquidity reporting information. Further work is needed on how to handle state of necessity situations, if a home country supervisor fails to comply with collaboration rules. We are looking forward to see a proposal from the Commission in this area.

Treatment of intra-group transaction and commitments
Finanstilsynet finds the Commission Services strikes a balanced approach with a symmetrical treatment of intra group exposures under the Liquidity Coverage Requirement, meaning the absence of inflow for one group member is mirrored as absence of liquidity outflow for another.

Monitoring tools
Finanstilsynet believes that a harmonized approach to common metrics used in monitoring the liquidity risk profiles of institutions generally is a good idea although supplementary metrics for national specificities prob-

ably will be needed. Especially harmonized market-related monitoring tools in this regard can be very useful as to monitoring of specific banks but also for financial systems.

Definition of capital

In general, Finanstilsynet supports the proposal to strengthen the definition of capital and to simply the capital structure.

We do, however, share the concerns raised in CEBS's comments concerning several of the issues regarding the definition of capital in the Commission Services' consultation paper. We strongly support the recommendations to rely more on CEBS guidelines that clarify the extent the specificities of non-joint stock companies may be taken into account.

In particular, Core Tier 1 instruments in non-joint stock companies are often not tradable. Holders of these instruments, should they wish not to hold the instrument any longer, will often have no alternative to redemption or buy backs. For such instruments it is important to have some flexibility concerning the possibility for redemption or buy backs, for example a possibility to seek prior approval from the competent authority to redeem instruments up to a certain size within a specified total limit and within a specified timeframe, provided that specific requirements on financial soundness are fulfilled.

We support using going concern Tier 1 capital as the basis for calculating the limits for large exposures, but this should, of course, as also stated in the consultative document, be done in conjunction with an appropriate recalibration of the current 10 % and 25 % limit.

We share the concerns raised by CEBS that a full deduction of minority interest in Core Tier 1 capital does not recognise that minority interest can support risks at the level of the related subsidiary and that a full deduction can have a significant and disproportional impact on certain financial groups. We therefore support CEBS' proposal that other alternatives to full deduction of minority interest should be considered further.

Finally, we understand that the proposed deduction of investments in other institutions and insurance undertakings from Core Tier 1 capital as opposed to the current 50 % Tier 1 capital deduction and 50 % Tier 2 capital does not imply any restriction in the current possibility for conglomerates entities that meet the test of integration at the conglomerate level, i.e. they are able to fulfill Article 7, 8 and 9 Directive 2002/87/EC (FICOD), to apply Article 6(2) FICOD and Article 59 CRD. Any review of these provisions should be treated separately in due course.

Leverage ratio
This section supplements the joint memorandum sent by Danmarks Nationalbank and Finanstilsynet of 7 April 2010.

Finanstilsynet supports to address the risks associated with high leverage levels, but we fear that introducing a leverage ratio into prudential regulation as a mandatory one-size-fits-all back stop measure may have unwanted effects on the activity of potentially a large number of credit institutions.

Credit institutions may be involved in very different activities; have different customer bases and risk profiles. Any universal back stop measure would very likely have either no effect on a number of institutions, where the restraint of such a back stop measure could be justified, and at the same time have an unnecessary restraining effect on the activity of other institutions.

On that basis we believe that any leverage ratio functioning as a restraint on the level of the lending of credit institutions should be based on the specific history and risk profile of the individual institution and be included in the calculation of the institutions' capital (solvency) need under pillar 2. This measure should, of course, be subject to supervisory assessment.

Alternatively, it may be considered to set reduced minimum leverage ratios for certain low risk institutions. For example, a 2 per cent ratio for mortgage-credit institutions may be appropriate as compared to a general leverage ratio of, say, 4 per cent for standard banks. The supervisor should have the possibility to increase such reduced leverage ratios on a case by case basis as part of the pillar 2 process.

It could be considered to let EBA develop binding standards for the supervisory assessment of the appropriate leverage ratio.

Finally, we can subscribe to the idea that further work is needed in exploring the design and calibration of the leverage ratio. The results of the QIS exercise will be essential in this process.

Also, we have some concerns regarding the interplay between any leverage ratio and the proposed quantitative liquidity standards. High quality liquid assets, which could be essential for having sufficient liquidity buffers, would contribute to the leverage ratio by being included fully in the total exposure amount. This could restrain the lending capacities of credit institutions. Finanstilsynet therefore welcomes that the Commission Services aims to assess the potential effect of excluding high liquid assets from the total exposure measure, as part of the QIS exercise.

Furthermore, we can subscribe to the need for a consistent leverage ratio definition that takes into account differences in accounting standards across countries.

Counterparty credit risk
Finanstilsynet broadly supports efforts to strengthen the capital requirements for counterparty credit exposures and to seek fully consistency with the changes to the Basel II framework.

Countercyclical measures
Finanstilsynet strongly supports efforts to strengthen the resilience of the banking sector by exploring countercyclical measures.

Through-the-cycle provisioning for expected credit losses.
The crisis has shown that there have been situations with pro-cyclicality effects when using the current incurred loan loss model in accounting and we therefore welcome initiatives to develop other models to achieve relevant financial reporting.

Although the IASB's Expected Cash Flow method is not finished, we see this model as a step in the right direction as this method conceptually achieves a more timely recognition of expected credit losses than the current incurred loss model and it reflects better the way banks manage credit risk.

We have an overall preference for waiting for the IASB to complete its standards on impairment, although we see attractive fundamental merits in the work done by the Commission Service. After the IASB has completed its work on the accounting standard on impairment, we are in better position to evaluate the need for further counter-cyclical provisioning measures in the accounting framework or the prudential framework. We should avoid overlapping work and potentially inconsistent developments.

Notwithstanding the above, it might be useful that further counter-cyclical measures are reflected in the bank's net profit in order to give the right incentives to management of the bank. At the same time we find it important that investors and other users of the financial statement are able to distinguish the provisions made as a result of counter-cyclical measures from the other provisions of the bank.

On that background, the suggested IRB approach could be a valuable enhancement. However, we believe that certain issues need to be addressed in further development of the proposal. Firstly, the proposal seems to be based on an incurred loss model in the accounting standards. It is not clear how the Commission's proposal could fit into an Expected Cash Flow model. Secondly, the proposal is based on the assumption that PDs (and LGDs) are trough-the-cycle. This is not always the case in practice as some banks have ratings systems that exhibit a certain degree of cyclicality. Converting cyclical PDs to a through-the-cycle measure is a non-trivial exercise and until this has been achieved, the efficiency of the approach would be reduced.

Capital buffers
We support the intention. However the appropriate level of calibration is, of course, an issue that must be considered carefully. We support setting restriction on the possibility of capital distributions although could make it more difficult for the banking sector to raise equity. Making the legally set capital buffer vary according to the economic cycle in a contra-cyclical way would be desirable, but will on the other hand add complexity and uncertainty to the system. An alternative countercyclical measure, that may be more objective and less complex, would be to relate the level for the restriction on the possibility of the capital redistributions to the level of credit growth in the individual institution.

Finally we wish to stress a strong need for predictability and clarity about the cyclicality element for capital buffers, since it is important for investors to a have as much as possible transparency. An opaque, non-transparent system of counter-cyclical capital buffers could be very harmful.

Systemically important financial institutions
Finanstilsynet acknowledges that large and interconnected banks can pose significant risk to financial stability. Finanstilsynet also notes that other firms, shadow financial structures and infrastructure providers can potentially be systemic.

Finanstilsynet finds the efforts to strengthen capital and liquidity requirements will enhance the resilience of all banks in itself. It will reduce the risk of failure in the future and make failures less costly.

Finanstilsynet notes the overall framework in this area needs considerable further refinement, although good progress seems to be underway. However, the complexity of the topic as well as data gaps should not be an excuse for not making further progress.

Finanstilsynet believes it is important to improve the system's capacity for an orderly resolution to a large, complex cross border groups failure.
More proactive supervision of systemic important institutions could also be considered.

Finanstilsynet finds that measurement of systemic importance is very complex and it cannot exclusively rely on ratios and numbers but must also involve a judgemental aspect. The judgemental aspect will take into account whether institutions' strategies, policies, processes and systems are proportionate to the complexity, risk profile, scope of activities and reflect on the institution's importance across financial sectors and markets.

Finanstilsynet finds it satisfactory that the Commission Services concludes restrictions on size - without regard an institution is abusing a dominant market position - is inconsistent with the EU approach.

Finanstilsynet is aware that the size of financial institution is often used as a measure of systemic importance and Finanstilsynet would like to stress that such a measurement should not only be based on a ratio based on the national market size, since this could imply stricter regulation for financial institutions from small countries and it could distort the institutions' competitiveness both in relation to national and other European competitors.

Single rule book in banking
Finanstilsynet welcomes the efforts of the Commission Services to establish a single rule book.

Finanstilsynet generally supports elimination of national discretions and options and the development of binding technical standards. Both initiatives will contribute to establishment of a single rule book.

Finanstilsynet welcomes the view of the Commission Services to keep some forms of flexibility with regard to regulation of real estate lending. It is vital that the goal of harmonisation is not pursued at the expense of well-functioning national system like the Danish mortgage credit model. In this connection, Finanstilsynet misses an overview of which characteristics will be maintained under a single rule book.

In Denmark the setup of credit institution regulation is two-stringed and distinguishes between banks and mortgage banks, where both types of business organizations are credit institutions in the EU terminology. Finanstilsynet would like to highlight that it is of paramount importance to Denmark and our financial stability, that the amendments remain sufficiently flexible in order to safeguard a continuation of our system of mortgage credit under the framework of single rule book.

Danish mortgage banking differs from conventional banking mainly because mortgage banks in the regulation are prevented from taking deposit or from using interbank markets to fund their lending. Both mortgage banks and conventional banks may issue covered bonds, but only mortgage banks may issue so-called covered mortgage bonds and so-called mortgage bonds, since such designations enjoy a name protection in the regulation.

The main further features of the legal framework for mortgage banks are:

- Mortgage banks grant loans secured by mortgages on real property. A limit has been determined for every loan relative to the assessed value of the property financed (LTV limit). Further, the loans are subject to a number of provisions on terms and interest-only periods.
- Mortgage banks must observe the rules of the Finanstilsynet when assessing the value of a property.
- Mortgage banks have only one source of funding: bond sales.
- Mortgage banks must observe a balance principle when issuing bonds.
- The system is safeguarded with personal liability for the loans coupled with efficient foreclosure procedures.

The "Balance principle" as a prudential rule

In Denmark, institutions licensed to issue mortgage bonds, covered mortgage bonds, covered bonds and other securities with preferential status, debentures and bonds issued by Danish Ship Finance shall comply with a balance principle.

This principle effectively limits liquidity risks and other financial risks apart from credit risk in mortgage banks. Under this principle, there is a close match between the loan which a property-owner raises with the mortgage bank and the bonds which a mortgage bank issues to fund the loan. The principle is a cornerstone of the Danish mortgage system, because it to a greater extent limits the risk the mortgage bank may incur.

Within the balance principle the mortgage bank can chose between two types of liquidity requirements. One is very tight requirement and the other is a more flexible requirement allowing for wide use of derivatives and avanced techniques to keep risk within certain limits in the regulation. In both versions of the balance principle, the same types of restrictions are imposed in areas like interest rate risk, option risk (prepayment risk) and foreign currency risk that follow from cash flow differences in the balance sheet. The balance principle also contains a number of other provisions regarding required risk management standards.

As the balance principle plays a vital role for financial stability Finanstilsynet strongly wishes to continue with this prudential rule.

Other prudential rules
Finanstilsynet also wishes to draw the Commission's attention to other types of statutory prudential standards, which are in place:

Intra-group exposure must be approved by the supervisor:
In Denmark, financial undertakings may not, without prior approval from Finanstilsynet, have exposures within the same group except for exposures with subsidiary undertakings. A similar ban exists with other undertakings or persons who exercise direct or indirect controlling influence in the financial undertaking, or who are controlled by undertakings or persons with such an influence.

Finanstilsynet wishes to emphasize that this prudential rule proved its importance, as it contained the contagion under the financial crisis. The supervisors' approval takes into account the own funds of the institute on a case by case basis. This rule is of great significance to the financial stability of the financial sector.

Finanstilsynet strongly wishes to continue with this prudential rule.

Limits on investment in and holding of investment property or holdings in equity investments in property companies as a prudential rule for banks, mortgage banks and investment firms regarding:

In Denmark, a 20% limit of the own funds has been set up to limit the size of firms' investment in the property market in order to restrict or narrow any conflict of interest between being a lending agent and a principal player at the same time. Finanstilsynet can grant a firm an exemption from the limit.

The rule dates back to the times of depression in the early thirties of the last century. Finanstilsynet finds the rule is useful and effective.

Finanstilsynet wishes to continue with this prudential rule.

Treatment of real estate lending
In principle Finanstilsynet has an open view on a revision of preferential prudential framework of exposures secured by real estate property. Finanstilsynet is aware of that real estate markets differ widely within the EU.

Further convergence of preferential treatment of real estate lending would not necessarily lead to a level playing field, since differences on issues as regards options and speed of enforcement of claims and personal liabilities for loans still exists. For that reason Finanstilsynet must conclude that the "substantial margin" requirement may continue.

An introduction of a Loan-to-Income measure is undesirable. It would complicate the regulation in the opinion of Finanstilsynet. Creditworthiness is much broader and complex than an income element; Credits should be granted on the basis of a customer's financial circumstances and on specific background assessments; Facilities should reasonable match the customers' financial situation, including capital position and assets and the customers must be able to demonstrate repayment ability.

Generally Finanstilsynet finds the market valuation principle desirable, but in case of euphoria or significant growth rates in market prices it could be relevant to supplement the market valuation principle with additional measures. For example less preferential treatment of real estate lending could be a solution in such circumstances. Also it could be considered to lower the actual lending limits in such circumstances.