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EESTI PANK

Possible changes to the Capital Requirements Directive
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Bank of Estonia's response to the EU Public Consultation regarding further possible changes to the Capital Requirements Directive

We would like to thank the European Commission for the opportunity to comment on the possible changes to the Capital Requirements Directive (CRD). In general, the Bank of Estonia considers that the proposed changes to the CRD are important steps forward and will contribute to enhancing financial sector resilience in the EU.

Considering the specific proposals, we wish to make the following comments:

1. Through-the-cycle expected loss provisioning

While we agree with and support the main intentions of the proposals on dynamic provisioning we urge the Commission services to continue work in this area to identify and achieve a solution that would best address the shortcomings of current regulation without compromising the benefits of current regulation. One of the values that the current regulation holds we see to be the transparency of the actual financial situation of an institution.

2. Specific incremental capital requirements for residential mortgages denominated in a foreign currency

While we agree that the responsibility and reliability of credit intermediation for consumers and households should be ensured, we are very puzzled with the proposed amendments to the CRD that single out and are aimed at one particular market segment, notably foreign currency denominated mortgage lending.

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In our view, the proposed amendments would improve neither the efficiency of single financial market nor risk management in financial sector. It is highly doubtful whether they would address the issues of consumer protection or financial literacy. Indeed, the suggested amendments would raise important and fundamental questions in respect of ensuring free movement of services and capital in the Single Market, and providing access to credit by corporations and individuals in the European Union.

At this stage, we would like to point out three key concerns.

- Firstly, the proposal fails to provide any significant proof, that the foreign currency denomination has been the cause of market distortions regarding residential mortgage markets prior the financial crisis or, indeed, that mortgage owners were or are somehow financially illiterate and do not take personal financial risks appropriately into account.

  The household's credit growth was strong worldwide and the problem of irresponsible lending and borrowing existed irrespective of the currency composition of the household loans. It has been equally evident in countries with fully domestically denominated mortgage credit (e.g. USA, several Euro Area countries, etc.). Therefore, we are not convinced that such provisions would have prevented the expansive worldwide or even regional mortgage growth in the previous years, which makes the real value added of the amendments questionable.

- **Secondly, the proposal fails to provide a link between the actual foreign exchange risk of different foreign currencies and the proposed risk weighting of residential property loans issued in these particular currencies** (currently proposed as 1250% regardless of the actual risk). As such, the proposed approach deviates significantly from the risk based approach of foreign-exchange risk calculation, where the correlation between currencies has been taken into account. While we see some justification in taking currency risk into account in household credit products, we find it to be more appropriate to have a wider scale of risk weightings available, considering the actual exchange rate risk, rather than applying the proposed 1250% penalty rate on all foreign currency loans.

  Hereby we would like to underline that the foreign exchange risks of EUR denominated loans, especially if the Member State which participate in the ERM-II and/or have a pegged exchange rate regime, are not comparable with the foreign exchange rate risks vis-à-vis third currencies under floating exchange regimes. Thus, we do not find it appropriate to apply the same risk weighting on the above described EUR denominated loans as on loans in third currencies.

  In our view the appropriate risk weighting should, in minimum, take into account (i) whether the mortgage loan is denominated in EUR or in a third currency; and (ii) the particular exchange rate regime of the Member State, including the participation in the ERM-II.

- **Thirdly, the proposal fails to address other relevant, and *most probably more important* risk factors, like interest rate risk.** The proposal fails to take into account the popularity of floating-rate mortgages in recent years and especially in these Member States, where the foreign currency denominated mortgages tend to prevail. Usually the short-term market is the most developed segment of domestic financial markets; hence it would be reasonable to presume that the share of floating rate mortgages would have been even higher if the mortgage market was forced to be domestic currency oriented. The proposed 50% Loan-to-Value threshold is also lacking practical or theoretical underpinnings.

In sum, while lessons from the recent crisis are yet to be learned, it seems reasonable to suggest that the financial sector and households' situation could have been much worse, if the proposed provisions would have been in place before the crisis. Our experience indicates that domestic interest rates reacted much more strongly to the financial market crisis than the euro interest rates. Given the overwhelming majority of floating-rate mortgages in our region, the impact of financial crisis on households and financial industry would have been significantly harsher and widespread, if the mortgage market would have been domestic currency oriented.

Therefore we are not convinced that the reduction of presumable foreign exchange rate risk would have reduced the total risk - rather to the contrary. Based on the above, we have serious reservations concerning the harshness of the proposal, which clearly aims to stop foreign currency denominated lending in future.

3. Removal of national options and discretions in the CRD

We agree with the Commission main intentions to reduce national discretions and we express our general support on the clear message for the need for further convergence of regulation. At the same time, we are in a strong view that the scope of maximum harmonization should be limited on the ungrounded or harmful regulatory differences.

More particularly, we are on an opinion that as long as financial stability is a national responsibility, Member States should be entitled to apply more stringent measures, if considered appropriate by them, in order to safeguard financial stability. Therefore we have some particular concerns with the proposed approach by the Commission services:

- **Firstly, we are not convinced that the possibility for more stringent national measures can be limited only to specific risk assessments e.g. Pillar 2 measures.** In Estonia one of the most important financial stability measures has been the 10% minimum capital requirement applied to all credit institutions. It would be legally far more difficult and confusing to implement this measure through Pillar 2 framework rather than through Pillar 1.
- **Secondly, the developments in financial stability tools should be in balance with national obligation regarding financial stability.** Therefore we find that the timeline for aiming for maximum harmonization of regulation should take into account the relevant developments in pan-European crisis management and burden sharing topics. In our view these timelines should be harmonised – i.e related rather than separated and therefore it is too early to settle concrete deadlines for the maximum harmonization of regulation.

We also would like to emphasize that CEBS has carried out a comprehensive work last year in mapping the discretions in the Directive which could and should and which should not be harmonised at this stage and we support the general approach of the Commission services to continue the work on the basis of CEBS contribution.

Section 4. Simplification of the Branch Accounts Directive

We agree and support the Commission services intentions to reduce additional reporting requirements for branches.

We nevertheless underline that it is important that the annual report of the financial institution is required to be made available also in the official language(s) of the Member State where the branch is operating. Therefore we are on an opinion the Member States should be left with regulatory rights to require the financial institutions to publish their annual reports in the official languages of the Member States where they operate.

Yours sincerely

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