Joint Comments of the Ministry of Finance of the Slovak republic and National Bank of Slovakia
on
COMMISSION SERVICES STAFF WORKING DOCUMENT „POSSIBLE FURTHER CHANGES TO THE CAPITAL REQUIREMENTS DIRECTIVE“
(EBC/007/10)

A. GENERAL REMARKS

We very much welcome the initiative of the European Commission to start a public consultation regarding possible further changes to the capital requirements directive.

From our point of view the Commission services staff working document provides a good starting point for the discussion on possible changes. In this document, we would like to outline some of our remarks and comments regarding this initiative as outlined in the Commission services staff working document and we believe that taking on board the comments expressed below would enrich and balance current discussion and help to reach the objectives of this consultation.

B. SPECIFIC COMMENTS/ANSWERS TO INDIVIDUAL QUESTIONS

1. LIQUIDITY STANDARDS

Generally, we welcome the proposed harmonisation of liquidity standards which is crucial for the improvement for the liquidity risk management of credit institutions. We also welcome the concept of quality indicators for liquid assets. From the supervisory point of view we agree with the fact that institutions should be able to meet the LCR at the individual level and not at consolidated level

It is necessary to consider the feedback effect of the regulation on the liquidity situation of the financial markets. In particular, the structure of highly liquid assets indicates that there might be a crowding-out effect regarding investment into securities which are eligible for highly liquid assets vs. other securities. For instance, corporate bonds might be more preferred than (non-covered) debt securities issued by financial firms (or other non-eligible debt securities), which in turn might have impact on their pricing and spreads. In addition, since an adverse change in characteristics of debt securities (downgrading or large negative price movement) causes that a previously eligible security might become non-eligible suddenly, it might imply selling out of such securities and further inflicting negatively liquidity situation of the institution issuing the security.

Moreover, such an adverse change might have also sudden negative impact on the value of both liquidity ratios.

Furthermore, there is a risk of moral hazard due to the eligibility of all domestic debt securities irrespective of their rating and other characteristics. Finally, previously highly liquid assets might become illiquid during a financial crisis, since in case of liquidity shortfall in financial markets, institutions will held these eligible assets in their balance sheets and the markets might become frozen.

The issue of public disclosure of both liquidity ratios should be carefully considered. In particular, publication of these ratios in the initial period after their implementation might not be well understood by the market participants and might cause their exaggerated response. We propose to defer the publication of these ratios to a later phase after the implementation.

Regarding the liquidity coverage ratio, one the main issue is the definition of distinction between stable and non-stable deposits. This definition is crucial for the values of this ratio, mainly for retail banks. In our view, this definition should be proposed in the clear manner with well-defined criteria which are verifiable based on available data. However, it should remain pragmatic and practically applicable.

In addition, the definition of highly liquid assets should be further clarified. For example, it is not quite clear whether covered bonds issued by financial institutions (not including the reporting institution itself) could obtain the haircut 20 % if they are rated AA or above, bid-ask-yield spread has not exceeded 40 bsp and the maximum historic decline of price or increase in haircut has not exceed 10%. In addition, it could be more clarified what does "domestic sovereign or central bank debt in domestic currency" mean for application on consolidation basis. In our view, it should mean that if a subsidiary has debt securities issued by its domestic government, they should be also eligible for the parent company on the consolidated level in any case, even if they are not considered as "domestic debt securities" for this parent company.

Regarding the net stable funding, we would like to comment on two main issues:

1. Although it is explicitly given that "domestic debt securities" are eligible for the Liquidity coverage ratio, it is not clear whether they are in any case eligible for the preference weight of 5 % in the net stable funding ratio. We strongly propose that the definition of both these ratios should be harmonized in this case.
2. According to a preliminary quantitative estimate of the values of this ratio, it seems that the setting of this ratio might be rather stringent for several banks in Slovakia. In particular, the coefficient of 85 % for retail loans with residual maturity up to 1 year in calculation of the required stable funding seems rather high, since the bank has discretion whether or nor to have these assets liquid after their repayment.

Treatment of intra-group transactions and commitments

We believe that question of **asset transferability** is a very complex issue with regard to the commercial and company law and we are very sceptical as for feasibility to explore the concept of the banking group. "Financial group interest" cannot not be placed above the responsibility of the Member States to maintain the financial stability on their territory. This concept is also in contradiction to the Council and ECOFIN conclusions.

We do not support any changes in the current regime of intra-group asset transfers, as allowing transferability of assets would represent a serious interference into the MS competences in liquidity management.

Currently, intra-group asset transfers are required to be carried out under commercial terms, at arms' length principle subject to prudential requirements embodied in CRD and national legislation. Changes in the current regime of intra-group asset transfers that are envisaged in Commission documents have a potential not only to undermine the interests of shareholders and clients of transferor bank as suggested in the document, but they also interfere with the responsibility of

national regulatory authorities for preserving financial stability in their individual Member states, especially in case when a transferor bank fails to meet regulatory standards after the capital is transferred to other entity within the group.
In our estimation, allowing for transfer of assets would be accompanied by elimination or revision of intra-group large exposure limits and abridging powers of national authorities regarding liquidity management by banks. While enabling thus a quick transfer of assets, we are deeply concerned about the increase in potential for brand contagion throughout the group and consequently across all national (interbank) markets where the related group is present.
We believe that the current regime of intra-group asset transfers, which is embodied in the CRD and national legislation, is well balanced and provides adequate safeguards for parent companies as well as their subsidiaries and already has proven to be a useful instrument in preserving a stability of the national financial sector.
We therefore believe that changes to the current regime of intra-group asset transfers do not represent an appropriate way forward and emphasis should be instead put on development of other early intervention tools which would be more efficient and justified within the context of the exploration of a new EU crisis management structure

Supervisory responsibility for branch liquidity
Regarding the supervisory responsibility for branch liquidity, we do not support proposed changes of the current wording of Art 41 CRD.
Liquidity of branches can have a major impact on the financial stability of Member States. Therefore, if the common standards for liquidity should limit the power of the national supervisory authorities to regulate this area without adequate requirements for liquidity of branches- not even during the crisis- this could lead to financial instability particularly in Member States where branches have a significant position. Moreover, even if branches have not significant position in the banking sector now, the situation could reverse at any time.
In the case of a foreign bank failure or significant weakening of confidence in financial position of the parent bank, this would also mean a failure or doubts about financial position of the branch. Direct negative effect will be felt in the form of an increase of uncertainty among customers and creditors of the affected branch (and also of other still sound branches) and cause direct losses in case of exposure to a failed branch. In the case of systemically important branch of foreign bank its problems may start a chain reaction and disrupt the functioning of the entire financial system with significant impact on the real economy.
With the liberalisation of branch liquidity regulation, many parent banks, including systematically important banks, would be incentivised to change their strategy and internal structure and transform their subsidiaries into branches. Consequently these changes will trigger major liquidity outflow with immediate impact on local banking sector.

A transformation of subsidiaries into branches and unregulated liquidity outflow from a host member state could cause financial instability due the increased possibility of default of such branch which could further trigger uncontrolled withdrawals of deposits by population, create the atmosphere of distrust in the financial market of the member state concerned. Moreover instability of one particular systemically important institution will with all probability spread over financial market and cause instability of other financial institutions. Such situation could have further

repercussions on other Member States and wider regional impact. For this reasons we are of the opinion that a regulation of liquidity of branches by host regulator is the essential tool to prevent aforementioned negative consequences.
Before any discussion about proposed changes of Art 41 CRD, we believe that it is important to know how common standards for liquidity in EU could possibly look like and how they could affect the host regulatory powers concerning the regulation of liquidity of branches.
If there should be new common standards regulating branch liquidity requirements, they shall do it in such manner that will give all safeguards for the financial stability of Member States where branches have or might have a significant position.
In this regard in our opinion the discussion about changes of Art 41 CRD at this stage and without any necessary clarifications and safeguards is premature.

2. DEFINITION OF CAPITAL

Overview

We generally support the effort of the Commission to simplify, harmonize and reinforce the definition of capital at the EU level. However, without results of a comprehensive impact study we are not able to assess the quality of proposed changes in internal limits of capital. On the other hand, we support the widening of disclosure requirements of banks regarding capital provided that the bank could still choose which information will not be published because of their confidentiality, insignificancy or in case of internal information.

Revision of the regulatory capital structure

We welcome the efforts to reverse the capital item "tier 3". We also agree that this item, definition of which is rather complex , should be withdrawn, as it did not perform a useful role during the crisis and facilitated a gearing based on capital that was of insufficient quality to be able to absorb losses on a going concern basis. We also consider that capital required to cover risks in the trading book should be of the same quality as the one required to support risks in the non-trading book.
In the case of the Slovak Republic its elimination from the definition of capital will have no quantitative impact. On the contrary, this elimination will contribute to ease the definition of capital, which in our view is a good basis for regulatory capital requirements.

Proposed definition of Core Tier 1 Capital

We welcome the initiative of Commission to limit the “core tier 1” capital only to common stock, since it corresponds with our current legislation (the inclusion of employee shares is limited). Exclusion of other possible kinds of capital instruments from the items of "capital" of the bank will have no quantitative impact on our banking system.

Prudential filters and deductions

We think that minority interests should not be deducted from capital. The capital ratio is calculated from a full amount of capital in subsidiary not just from the majority part.
The list of items of deferred tax assets which could be deducted from capital shall be done by national regulator; the Income Tax Laws being different in MS, reflecting possibilities countries have.

3. LEVERAGE RATIO

What should be the objective of a leverage ratio

Generally, we agree with the overall philosophy of the indicator, i.e. to avoid the pre-crisis situation where banks, even if requirements on own resources have been met, were still poorly capitalized. We also think that such a rule may also positively affect the process of creating new money and can reduce the likelihood of price bubbles.

At the same time, it should be recalled that some items included in the proposed “leverage ratio” affect the philosophy of the indicator of capital adequacy. Particularly, off-balance sheet transactions, which themselves do not create "leverage" until the moment they materialize , i.e. they are transferred to the balance sheet. Therefore, it would be useful to clarify the reason for their inclusion in the definition of "leverage ratio".

We also consider important to exclude the debt instruments from the definition of capital and tend thus to a narrow definition of Tier 1. Moreover, the “leverage ratio” should not substitute for monetary policy countercyclical measures.

4. COUNTERPARTY CREDIT RISK

Multiplier for the asset value correlation for large financial institutions

We propose that the limit for the value of assets of regulated financial institutions is not set as a strict number, but rather that the correlation is increasing in respect to the value of the respective regulated financial institution.

5. COUTERCYCLICAL MEASURES

IRB approach with respect to the through the cycle provisioning for expected losses

We consider the method beneficial in several ways:

- It uses the database and calculations which banks have already introduced,
- Is not dependent on the creator of accounting standards,
- It serves as an addition for Accounting Standards,
- It is full in the responsibility of regulatory authorities.

Its disadvantage is that the provisioning is above the line, which may raise some questions about the true and fair view in the financial statements.

Capital buffers

In our view creation of those "buffers" or additional reserves within own resources of the institution is a reasonable approach. However, it is necessary to consider whether creation of additional capital reserve in the time of growth may not have adverse effects on credit expansion and the economic development. In addition, we propose not to restrict paying of dividends, but rather to require banks to increase their capital by the amount equal to the dividends which are paid above the limit.

Appropriate timing for the restriction to capital distribution

We would opt for the introduction at the same timing across the EU, even though Member States should be entitled to apply such a restriction ad hoc.

The most suitable macro variable for the counter cyclical buffer

In our view the relation of “GDP versus loans” can be considered as an appropriate indicator for measuring economic equilibrium. It is also possible to include such indicators as inflation or mortgage bubbles in the calculation of this "dynamic buffer".

6. SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS

Regarding systemically important institutions we consider the reinforcement of supervision, an increase in capital and sufficient information for the analysis for the purpose of early intervention to be the most appropriate means of measuring and addressing systemic importance. It is important however to aim at achieving level playing field if any preventive measures in respect of internationally active SIFIs are to be taken.

7. SINGLE RULE BOOK

“Question 48: In which areas are more stringent *general* requirements needed given national or other circumstances? Is Pillar 2 a sufficient tool to address *specific* negative circumstances at credit institutions and if not, how could it be strengthened?”

There are a couple of areas that potentially could impinge on financial stability of a member state, who is in this case a host country regulator. In some areas the shifting of decision powers from the national regulator to the decision of a financial institution would not be acceptable based on the same reasoning.

Question 51: Should the prudential treatment for exposures secured by mortgages on residential property be different from the prudential treatment for exposures secured by mortgages on commercial real estate? If so, in which areas and why?”

As regards the possible indicators for preferential treatment of real estate for housing and business (and their possible values), we welcome the Commission initiative. At the same time, however, we point strongly to the need to perform an impact study with the involvement of the widest range of relevant authorities before any suggestion of the indicator´s values for preferential treatment for housing and business will be made. This study is important because the possibility of waiving the condition for preferential treatment – the risk of borrower must not materially depend upon the performance of underlying property or project – as proposed by the CRD IV is transfer from competent authority to the bank.

“Question 52: What is your view of the merits of introducing measures that would help to address real lending throughout the economic cycle? Which measures could be used for such purposes? What is your view about the effectiveness of the possible measures outlined above?”

Regarding this question it is important to consider following aspects:

a) any proposed measure should be consistent with countercyclical measures (mentioned in section V of this document),

b) any proposed indicator and its values (adjustment factor, the explicit value of mortgage lending value etc.) should be a subject of an impact study involving the widest range of relevant authorities.