FINANSTILSYNET

European Commission
Internal Market and Services DG
Financial Institutions
Banking and financial conglomerate

DIRECTOR GENERAL

16 June 2008

DANISH FINANCIAL SUPERVISORY AUTHORITY
Gl. Kongevej 74 A
DK-1850 Frederiksberg C

Tel +45 33 55 82 82
Fax +45 33 55 82 00
finanstilsynet@ftnet.dk
www.dfsa.dk

MINISTRY OF ECONOMIC AND BUSINESS AFFAIRS

Please find our comments on the public consultation on possible changes to the Capital Requirements Directives (2006/48/EC and 2006/49/EC).

The Danish Financial Supervisory Authority appreciates the opportunity to comment on the consultation document "CRD POTENTIAL CHANGES, Co-decision, Comitology".

Henrik Bjerre-Nielsen

MEMO

EUROPEAN COMMISSION
Internal Market and Services DG
FINANCIAL INSTITUTIONS
Banking and financial conglomerates

DANISH FINANCIAL SUPERVISORY AUTHORITY

16 June 2008

J.no.

Comments on the public consultation on possible changes to the Capital Requirements Directives (2006/48/EC and 2006/49/EC).

The Danish Financial Supervisory Authority appreciates the opportunity to comment on the consultation document "CRD POTENTIAL CHANGES, Co-decision, Comitology".

Our contribution can be published on the web site of the Commission services.

A. Large exposures and treatment of intra-group exposures and covered bonds

1. **Treatment of intra-group exposures (art. 113(1f) in the proposal/existing art. 113 (2))**

We are concerned about the Commission's proposal to delete the national discretion of the current Article 113(2) that allows for a full or partial exemption of intra-group exposures from large exposures limits when counterparties are covered by the same or equivalent supervision on a consolidated basis and instead to align the treatment of intra-group exposures with the capital requirements treatment of exposures to counterparties that meet the conditions in Articles 80 (7)(a-c) and (e) or 80 (8). These provisions allow Member States to fully exempt them from large exposures limits provided that they are satisfied that the group could and would provide solvency support as necessary. Where any of the conditions in Article 80 (7)(a), (b), (c), or (e) or any of the conditions in Article 80 (8) are not met, exposures should be treated as exposures to a third party, i.e. subject to the backstop limit.

We have reasonable doubt whether article 80 (7)(e) can be fulfilled ("*there is no current or foreseen material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities from the counterparty to the credit institution*") and therefore in our opinion the exemption of intra-group exposures can not be granted.

We believe further that when a financial firm incurs an exposure to its own parent undertaking or to other subsidiaries of its parent undertaking, particular prudence is necessary. The management of exposures incurred by financial firms should be carried out in a fully autonomous manner, in accordance with the principles of sound banking management, without regard to any other considerations. We also find that in the field of large exposures, specific standards, including more stringent restrictions, are necessary for exposures incurred by a financial firm to its own group. These principles above are recognised in preamble no 52 of 2006/48/EC.

In our legislation we have in place rules that take into consideration that intra-group exposures can imply specific risk, because it follows from the nature of a group that the parent company can make decisions in subsidiary companies as a dominant shareholder and in this way can exercise indirect influence on decisions, which are decided on subsidiary level.

We prefer to see no impediments in the EU Directive that could hinder us in keeping our present rules which have been in place for more than four decades. We do not see our rules in conflict with interests of the internationalisation process in the financial sector. In addition we find that our rules work appropriate and are based on sound principles for crisis prevention. Our grounds for the rules are firstly motivated by setting obstacles towards an abuse by a dominating position over a financial firm which could harm depositors and secondly setting obstacles in letting economic imbalances in a group company spread to the financial firm which could lead to risk for loss for its depositors. And finally our rules do not hinder financial transactions between group companies, but set a requirement that an exposure can not legally arise without the consent of the supervisor. The supervisor is therefore in a position to set limits for intra group exposures

We would therefore strongly recommend to retain Art. 113 (2) in its current form (i.e. "*Member States may fully or partially exempt…*"). …..

2. Treatment of covered bonds (art. 113(2) in the proposal/existing art. 113 (3 (l)).

It is very important for the financial system in Denmark that this national discretion stays in the Commission's proposal.

The Danish covered bond market is Europe's second largest after the German Pfandbrief market. It is more than 35% larger than the Spanish covered bond market and almost twice the size of the French.

Real property finance in Denmark is mainly based on mortgage lending raised through mortgage banks. The mortgage activities are funded exclusively through the issuance of covered bonds, which explains the size of the Danish covered bond market of EUR 295bn in April 2008.

Monetary institutions hold more than 40 percent of issued mortgage bonds in Denmark. Banks hold covered bonds for various reasons, and among them are safety and liquidity reasons.

Moreover Danmarks Nationalbank has accepted all Danish mortgage bonds as collateral in lending transactions with commercial banks and mortgage banks. This step has increased the flexibility of the financial sector's repo financing of investors' positions in mortgage securities. In addition Danish mortgage bonds would be eligible for inclusion on the ECB's Tier 1 list of collateral if Denmark should enter into the EMU.

Since the first rules concerning Large Exposures in directive 92/121/EU were implemented in Denmark we have assigned exposures consisting of bonds issued by the Danish Mortgage Credit Institutions with a weight 0,1.

If this member state option is deleted and as a consequence covered bond that falls within the terms of Annex VI, Part 1, points 68 to 70 will be assigned a weight of 1, we can foresee a disastrous blow to the Danish Market for Mortgage Credit Bonds. The demand for Mortgage Credit Bonds will be curbed and the funding side would be seriously disturbed.

Furthermore if the national discretion would be deleted from the framework, it would also raise immediate serious consequences for the liquidity risk management by banks.

We would therefore strongly recommend to retain Art. 113 (3 (l)) in its current form (i.e. "*Member States may fully or partially exempt...*"). .....

B. Hybrid capital instruments

In the working document the Commission services asks for views whether an additional limit would be useful to improve even further the quality of capital e.g. by requiring firms' core capital (equity, reserves and retained earnings) to be higher than a pre-determined proportion (e.g. 50%) of minimum capital requirements?

In Denmark we see it as an obligation to ensure that the overall quality of the institutions´ own funds are as high as possible.

In our opinion the eligibility of hybrid capital instruments to count as original own funds should be limited.

Therefore in Denmark it is now a demand, that the core capital (that is the total of the items in points (a) to (c) minus (i) to (k) of article 57 shall be equal to at least 5/8 of the sum of minimum capital requirements set out in points (a), (c) and (d) of article 75 and the item in points (l) to (r) of article 57. If that demand is fulfilled hybrid capital instruments can be included in the original own funds up to a maximum of 15 % of the core capital.

The Commission´s proposal will expand the possibility of using hybrids as tier 1 capital.

Without an additional limit concerning the core capital´s part of the minimum capital requirements we believe, that the quality of the institutions´ own funds will diminish dramatically.

We could accept a lowering of the core capital´s part of the minimum capital requirements to 50 %, as it was stated in article 66 (1a) in the document (CRDWG/035/08), that was the basis for the discussions in the meeting in CRDWG on the 27th of March 2008.

Article 66 (1a) had the following form:

"1a. The total of the items in points (a) to (c) minus (i) to (k) of Article 57 shall be equal to at least 50% of the sum of minimum capital requirements set out in points (a), (c) and (d) of Article 75 and the items in points (l) to (r) of Article 57."

We therefore recommend to reinstate the wording of the above mentioned article 66 (1a) in at new subparagraph to article 66.

We recommend alternatively that the Commission postpones the regulation of the hybrid capital instruments until the Basel Committee for Banking Supervision (BCBS) has concluded its work on this matter.

C. Supervisory Arrangement

Article 40 (3) mentions that "The competent authorities in one Member State shall *have regard to* the potential impact of their decisions on the stability of the financial system in all other Member States concerned and, in particular, in emergency situations."

The text is not perfect aligned word by word with the ECOFIN conclusion of April 2008, which says

"The Council AGREES that the EU dimension should be taken into account in an appropriate way by national supervisors as follows:

– In the exercise of their responsibilities, the financial supervisors in the EU Member States should intensify work towards enhanced European supervisory convergence and their task should include cooperation at the EU level and among Member States within and across financial sectors.
– The enhanced EU dimension would in particular allow financial supervisory authorities *to consider* financial stability concerns in other Member States in exercising their duties and to apply guidelines and recommendations adopted by the EU Committees of Supervisors (level 3 committees) in line with the 'comply or explain' procedure. While guidelines and recommendations adopted by these committees are non-legally binding, those supervisors who do not comply should explain their decisions publicly."

We suggest aligning the wording in the text in the Directive closer with the ECOFIN conclusion.

Other reflections on issues in relation to the credit market turmoil

In the wake of the financial market turmoil – which began in the U.S. subprime mortgage market in summer 2007 and rapidly spread to Europe – many reflections have been done on how well our regulatory system is equipped to manage such events and a lot of good initiatives have been launched in order to prevent similar situations in the future.

We will not comment on all the suggestions for improvements which have been put forward in the ongoing discussions but concentrate on an issue related to financial transparency and hence the aim of improved market discipline: Disclosure of the result of institutions' individual capital assessment.

One of the triggers that blew distrust into the system was a lack of information on which institutions have been hit and the scale of potential losses. Several initiatives aimed at enhancing transparency have been launched in this area. However, one aspect is the transparency about risk from exposures, another aspect, maybe equally important, is the ability to absorb losses from these exposures.

With the implementation of the Basel II framework all institutions should have a process for assessing their overall capital adequacy in relation to their individual risk profile and a strategy for maintaining their capital levels, which in brief is called the Internal Capital Adequacy Assessment Process (ICAAP). A similar requirement is envisaged within the Solvency II framework, namely the Own Risk and Solvency Assessment (ORSA).

While the main purpose of the ICAAP is to enhance the link between an institution's risk profile, its risk management and risk mitigation systems and its capital in order to establish useful dialogues with its supervisor - we should also have our in mind that the ICAAP is a forecasting tool of how much capital institutions should hold in relation to their risk profiles, and we believe the results of the ICAAP are relevant for outside stakeholders. In this respect results include numbers as well as a summary of the deliberations.

Let us look at two banks (A & B) for illustrative purposes. Each of them has a capital adequacy ratio at 12.5 per cent. Let us assume that bank A has computed its ICAAP capital level at 9 per cent while bank B has computed its ICAAP capital level at 12 per cent. In the public the two banks might appear with equal capital strength, since they are reporting the same capital adequacy ratio and they show the same distance to the 8 per cent capital ratio threshold while the alarm bell might ring for supervisors for bank B that operates its activities close to the capital limits taking into consideration its overall risks which implies a smaller capital buffer for bank B compared with bank A. Let us assume then that both banks are hit by subprime related losses with equal magnitude which implies that the capital adequacy ratio drops to 11.5 per cent for both banks. In this scenario investors are unaware that bank B operates with an ICAAP capital level of 12 per cent. Its capital buffer is now considered negative and the bank is judged to be in financial difficulties by supervisors. Investors in the example could not only be misguided to believe that both banks operate with a substantial capital buffer. More important the uncertainty about banks' capital buffer may also make investors less interested to invest in otherwise well capitalized banks.

Lack of comparability across financial institution and complexity should not be an excuse for not requiring disclosure of the result of institutions' individual capital assessment. We are already confronted with these issues today as an implication of the application of IRB methods and the implicit discretionary assessments between banks.

We find that the current disclosure requirements under the accounting rules and pillar 3 might not address the situation with appropriate clarity. We suggest analysing further how more transparency of the results of the individual ICAAP to market participants can help to restore the confidence in the soundness of markets and institutions.

To sum up - under the present banking rules/accounting standards investors and other market participants are not necessarily equipped with the crucial information about the situation in banks, e.g.:

How much capital does the management think is needed in relation to the activities dealt with by the company?
And how does this assessment relate to the actual capital in the company?

We would find it to be step forward if financial institutions were required to disclose regularly the result of the ICAAP. In today's regime investors are unable to see if a financial institution is well-capitalised or just appears to be.