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European Commission
Internal Market and Services DG
Financial institutions
Banking and Financial Conglomerates

Consultation on CRD IV

Please find below the response by the Ministry of Finance of Finland to the questions set out in the Commission Services staff document on possible further changes on the Capital Adequacy Directive.

1. General comments

We support the proposed amendments regarding residential mortgages denominated in foreign currency and simplification of Bank Accounts Directive.

We also support the proposed amendments regarding national options and discretions, with the important exception regarding the lowering of loan to value ratios in chapters 9.1 and 9.2 of Annex VI where we think that the proposed limits are too tight. Finnish banks have not suffered significant losses from mortgage loans and the 70 % LTV values normally applied in Finland have proved to be adequate. We believe that significantly tighter limits would have a negative impact on real estate market, for instance by unnecessarily increasing the costs for home buyers.

While we are, in principle, in favour of mitigating the procyclical effects of the capital framework we do not consider the proposed provisions a working solution to the problem.

Most importantly, there is likely to be no data available for Finnish banks to calculate average historical losses over a cycle in a meaningful way, in particular as such data should be segregated with regard to asset categories and borrowers’ location. In the absence of such data, the provisions could only be based on subjective decisions, making the calibration too arbitrary to be meaningful.

Moreover, it does not appear to be meaningful to make any decisions regarding the applicable formulas before we know the outcome from the IASB. Even then, there remains a significant problem for small banks, which are not subject to the IFRS regime. For such small banks the proposed rules would be particularly difficult to apply regardless of the accounting solutions, further increasing their administrative burden. The possible impact of the IFRS amendments to the Bank Accounts Directive also need to be examined, in particular with a view to the most appropriate treatment of small banks.

In any case we find it important that accounting issues dealt with only in international accounting standards and in the Bank Accounts Directive but not in the CRD.

It also needs to be clarified how the proposed rules interact with the provisions related to the treatment of expected losses under the current IRBA rules, which already include counter-cyclical elements. It should be ensured that there will be no multiple impact for banks using the IRBA nor several different definitions for expected losses.

As far as legislative technique is concerned, we also find the proposed text quite inadequate. Firstly, it should be clearly established that the dynamic provisioning only concerns the regulatory capital regime and does not interfere with applicable accounting rules. Consequently, the Directive should lay down clearly what items shall be deducted from own funds when dynamic provisions are increased and how those items are later adjusted.

For above reasons, we believe that the most appropriate way of dealing with this issue at this stage would be a Pillar II approach requiring banks to include in their internal capital assessment process principles they intend to apply with regard to building up additional counter cyclical buffers.

2. Detailed answers

<u>Section I: Dynamic provisioning</u>

Question 1: What impact would the changes proposed in each section of this paper have on your activities or activities of firms in your jurisdiction, including costs linked to increase in regulatory capital and any other compliance costs?

In the absence of industry data it is not possible to calculate the impact of the proposed rules on the regulatory capital of banks. The introduction of formula based mandatory dynamic provisioning is likely to significantly increase the administrational costs of banks, in particular for small banks.

Question 2: Do you have any views about any aggregate impact of the proposed changes to capital requirements?

The aggregate impact of the various amendments to the capital requirements is likely to be significant. A sufficient time should be therefore allowed to draw up the various proposals and negotiate the proposals simultaneously. We are concerned about the various parallel initiatives leading to an “overkill” of the problem, causing unnecessary costs for banks both in terms of the price of capital and administrative burden.

Question 3: What is the optimal timing for these measures? Should their application be sequenced?

We do not believe it optimal to increase capital requirements in the current situation as it would be likely to slow down the economic recovery. This would also allow us time to improve the quality of the proposals and their impact assessments. The final decisions about the entering into force of the measures should be decided only after there is a clear view on the aggregate impact of the measures.

Question 4: The Commission services suggest that the through-the-cycle value adjustment should not count as regulatory capital (see ANNEX 1, suggested amendment to Article 57). Do you agree?

Article 57 covers both positive and negative items (deductions). The proposed text appears to say that dynamic provisions should have no impact on own funds in any way. This, in turn, would imply that they are already fully recognised in P/L statement and therefore need not be separately recognised in own funds. Should this be the case, it would be entirely inappropriate to include any provisions on dynamic provisions in the CRD.

Therefore, as set out in our general comments, we find it necessary to clarify the impact of dynamic provisions in own funds in detail (e.g. by adding new items in the list included in Article 57).

Question 5: Should off-balance sheet items be captured under the formula for through-the-cycle expected loss provisioning, given that 'provisions' for off-balance sheet items are not recognised in all relevant accounting standards? Should only assets subject to an impairment test be subject to through-the-cycle expected loss provisioning? (See ANNEX 1, suggested Article 74a (2).)

Our initial view is that it would be best to define the scope of dynamic provisioning as identical to the scope of impairment test.

Question 6: At this point, the suggestion is not to include the option for competent authorities to allow internal methods to determine expected losses across an economic cycle. As an alternative to the regulatory approach to calculate counter-cyclical factors, would it be desirable to allow firms' internal methodologies (to be validated by supervisors)?

We are not confident that mandatory quantitative requirements could be based on banks' internal models. See, however, our general comments on the preference of Pillar II approach, which could be supported by banks' internal methods.

Question 7: Should the exposure class of Article 86 (i.e. for credit institutions subject to the IRB approach) be used irrespective of the fact that the credit institution may be under the Standardised approach? It may be noted that a mapping between exposures class under the Standardised approach and under the IRB is already used in the prudential reporting system of some Member States. As an alternative, should countercyclical parameters be defined for the 16 exposures classes under the Standardised approach? (See ANNEX 1, suggested Article 74a (1).)

It would be preferable to use Article 86 exposure classes for all institutions even though we stress the practical difficulties of obtaining any meaningful historical data.

Question 8: Please give your views on the following approaches:

1) the Spanish model of through-the-cycle expected loss provisioning;

We refer to the earlier consultation, where we proposed a refined version of the Spanish model and we still prefer our model to the original. The benefit of our model is that it captures both the excessive growth of the balance sheet and the procyclicality issues (alpha and beta, respectively). Alpha here is a parameter related to the historical losses due to the exposures (for each bank), thus providing a level playing field. Beta is parameter that describes the scale that determines the additional provision stemming from the deviation from the historical provisioning.

$$DP_t = \sum_i \alpha_i \left(\frac{C_t - C_{t-1}}{C_{t-1}} \right)_i + \sum_i \beta_i (\overline{SP_t} - SP_t)_i$$

where DP_t stands for dynamic provision, SP_t for special provision, $\overline{SP_t}$ the historical (moving) average special provision over the cycle and C for loan portfolio. The summation is taken over exposure classes. The actual parameter values should be determined by the competent authorities or internal assessment, confirmed by the competent authorities.

The idea of our model is the following: if a bank's relative balance sheet growth is high, then there will be an additional provisioning, say x% of the historical losses times the relative growth factor (the alpha part). This captures the excessive balance sheet growth. Additionally, the dynamic provisioning is determined by the deviation of the current specific provisioning from the historical average specific provisioning over the cycle.

2) a 'simplified' Spanish model.

The main concern of any model is the availability of data and the estimation of proper parameters. However, we think that the model prescribed above is clearer and better compared to the one proposed by the Commision.

Question 9: Should new risk categories (as suggested above) be introduced along the lines of the Spanish system or, alternatively, should the current risk categories of the CRD (e.g. credit quality steps in Annex VI) be used? (See ANNEX 1, suggested Annex IXb.)

Current categories should be used in order not to further increase the administrative burden for banks.

Question 10: Is the 'location of the borrower' (as opposed to the booking of the exposure) the right approach, with a view to avoiding regulatory arbitrage? (See ANNEX 1, suggested Annex IXb 2.)

We find the location of the borrower the only logical approach.

Question 11: Will the data to determine counter-cyclical factors be easily available?

We believe that the lack of sufficiently detailed data is the main shortcoming of the proposed model, at least unless a sufficiently long time is allowed for the banks to accumulate the data before the new requirements must be complied with.

Question 12: Please give your views on the methodologies for calculating the through the-cycle expected loss provisions at consolidated level. (See ANNEX 1, amended Article 73.)

The provisions should be calculated only at consolidated level for two reasons:

1) Dynamic provisioning is likely to be based on the international accounting standards and the application of those standards is mandatory only at consolidated level, so this would be a consistent approach.

2) This approach would exclude intra-group items which are not relevant for the objectives of dynamic provisioning.

Question 13: Please give your views on the scope of disclosure requirements for through-the-cycle expected loss provisioning. (See ANNEX 1, suggested amendment to Annex XII (17).)

At this stage we find it premature to assess the disclosure requirements.

<u>Section 2 (Residential mortgages denominated in a foreign currency)</u>

Questions 14 and 15:

We find mortgages denominated in a foreign currency to be primarily a consumer protection issue and should be dealt with in the context of responsible lending rather than in the prudential framework.

<u>Section 3 (Removal of national options and discretions)</u>

Question 16: Is this suggested scope of maximum harmonisation in 2006/48/EC and 2006/49/EC appropriate?

Yes.

Question 17: Is the suggested prudential treatment for both residential and commercial real estate is sufficiently sound?

We strongly disagree with the proposed loan to value ratios (see our general comments).

Question 18: Is the suggested timeline (2012) for a single definition of default (i.e. 90 days) is appropriate.

Yes.

<u>Section 4 (Simplification of the Bank Branch Accounts Directive)</u>

Question 19: Do you agree that the Bank Branch accounts Directive 89/117/EEC should be amended so that Member States can no longer require the publication of additional information by branches of credit institutions established in other Member States.

Yes.