CNB CZECH NATIONAL BANK

NA PŘÍKOPĚ 28
115 03 PRAHA 1
CZECH REPUBLIC

Financial Market Regulation and
Analyses Department

Prague, September 2009

European Commission
Internal Market and Services DG
Financial institutions
Mr. Patrick Pearson
Head of Unit
Banking and financial conglomerates
Brussels
Belgium

Re

Czech National Bank Response to Commission services staff working document on possible further changes to the Capital Requirements Directive published on 24 July 2009

The Czech National Bank welcomes the opportunity to comment on a Commission services staff working document on possible further changes to the Capital Requirements Directive (CRD).
Please find attached an enclosure containing three parts: General response, Replies to individual questions included in the consultation document and Other comments and views regarding the document.

Enclosure

Pavel Hollmann
Executive Director
Financial Market Regulation and
Analyses Department

Pavel Vacek
Director
Financial Market Regulation Division

Czech National Bank
Financial Market Regulation and Analyses Department
Financial Market Regulation Division

2 September 2009

Response to Commission services staff working document on possible further changes to the Capital Requirements Directive

I. General Response

1) The effectiveness of some of the proposed measures has not been proven and we believe their circumvention cannot be ruled out in their proposed form. Prior to implementing any changes to the CRD, it is essential to conduct an impact assessment, i.e. to first analyse the impact of, in this case, stricter conditions, and only then submit proposed legislative amendments.

2) In general, it can be said that the rendered proposal will lead to a further increase in complexity and reduction in the clarity and comprehensibility of regulation. The system of regulation as a whole has already become quite confusing for regulated entities and supervisory authorities and has brought increased costs for both sides. Yet, if an ex-ante impact analysis of the proposed changes has not been conducted, it is not proven that the same objectives could not be achieved by much simpler means, specifically the rigorous application of existing regulation.

3) From the outset, the aim of the Basel II concept has been to increase risk sensitivity, reinforce institutional responsibility for internal risk management and to take their specific features into account during supervision.[1] The Basel Committee on Banking Supervision has also always pointed out that despite their increase risk sensitivity, both standardised and model approaches may not be able to capture all risks of major losses and must therefore be complemented by additional capital requirements pursuant to the Pillar 2.[2] However, transferring responsibility for the determination of individual coefficients for the whole

[1] „It is not the Committee's intention to dictate the form or operational detail of banks' risk management policies and practices. Each supervisor will develop a set of review procedures for ensuring that banks' systems and controls are adequate to serve as the basis for the capital calculations." ... „The revised Framework provides a range of options for determining the capital requirements for credit risk and operational risk to allow banks and supervisors to select approaches that are most appropriate for their operations and their financial market infrastructure." (International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version: June 2006)

[2] The revised Framework is more risk sensitive than the 1988 Accord, but countries where risks in the local banking market are relatively high nonetheless need to consider if banks should be required to hold additional capital over and above the Basel minimum. This is particularly the case with the more broad brush standardised approach, but, even in the case of the internal ratings-based (IRB) approach, the risk of major loss events may be higher than allowed for in this Framework. (International Convergence of Capital Measurement and Capital Standards: A Revised Framework, Comprehensive Version: June 2006)

market (see for example, coefficients α and β in the case of TELP) to the regulator, defeats the original aim of increasing risk sensitivity and own responsibility of regulated institutions, and nears the originally criticised concept of "one size fits all".

4) In principle, CNB rejects the creation of so-called dynamic provisions. It is of the opinion that the implementation of another new system is premature and that it should be preceded by an analysis of the current system. If the current system is judged deficient, modifications (in the context of IASB recommendations) must be proposed. At the same time, the system of creating so-called dynamic provisions must be analysed and if prospective modifications of the current system are not sufficient, then dynamic provisioning can be implemented as a counter-cyclical measure.

5) In general, CNB considers an increase in the risk weights for residential mortgages denominated in a foreign currency loans as a step increasing prudence. However, it considers the proposed system of penalty risk weights complicated and therefore proposes considering its simplification. What's more, it is unclear how regulatory limits were determined (e.g. the ability to use risk weights of 35 % to 50 % of the market value of property or even only up to 40 % for non-foreign currency loans, etc.) and whether this was preceded by an analysis based on concrete data. We are of the opinion that the proposed approach could be circumvented by allocating residential mortgages into a different, uncollateralised exposure class, thereby avoiding penalisation.

6) CNB supports the removal of discretions with the aim of creating uniform conditions under which regulated entities operate. For this reason, it does not object to the implementation of maximum harmonisation, provided this does not relate to regulations based on specific risk assessment, such as Pillar 2. The specifics of individual regulated entities reflected in supervisory authority measures, on which Pillar 2 is based, make harmonisation practically impossible in this area.

7) CNB has no objection to the elimination of discretion regarding additional requirements for the publication of information by foreign bank branches beyond accounting information for the institution as a whole.

II. Replies to individual questions

General questions

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?

CNB response:
Compliance with the requirements arising from CRD IV would require CNB to implement another analytical apparatus and create relevant databases with the collection of new data, i.e. a significant expansion in the reporting duties of supervised entities. This would not only represent one-off implementation costs, but also subsequent maintenance costs and specifically involve the need for further resources in relation to the implementation of

through-the-cycle expected loss provisioning TELP (dynamic provisioning) or evaluating the development level of the loan market collateralised by real estate property. Relevant costs cannot be quantified at this time. Total costs will depend on the final form of adopted solutions.

CNB does not currently have a quantification of the impact of changes proposed as part of consultation on the capital of institutions, e.g. also because the relevant coefficients α and β for the calculation of TELP are not known. In terms of the impact of changes in the area of residential mortgages denominated in a foreign currency on regulatory capital, the percentage of loans provided in foreign currencies is very low in the Czech Republic in general compared to the total number of loans. In the case of loans to private households (the market segment with a predominant share of housing loans, which make up circa 75 % of total loans in this segment) this percentage is practically zero. We therefore do not anticipate this measure to have a major impact on the capital of institutions in the Czech Republic.

It is clear that institutions that are active abroad would have to increase resources for acquiring information on decisions adopted by competent supervisory authorities, especially the use of various sets of coefficients (differing according to the debtor's location) set by individual supervisory authorities in individual Member States for the purposes of TELP.

In view of the fact that the Czech Republic does not require the branches of foreign credit or financial institutions from other EU Member States to publish additional information, this part of the proposed measure will not have any impact.

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

CNB response:
The aggregate impact of hitherto implemented and proposed measures is difficult to quantify in the given situation (incomplete draft amendments of CRD III and CRD IV). The degree of impact on the amount of regulatory capital will also depend on the degree of institutions' involvement in the activities in question. For example, given that the volume of the trading book within the banking sector in the Czech Republic is not large, the same as the involvement of institutions in the area of securitisation, we do not expect major impact from this perspective.

Institutions today have a tendency to maintain higher capital than laid down by regulatory requirements. If there were no change in approach, the anticipated increase in regulatory capital requirements could be partially absorbed by institutions' existing capital cushions, on the condition there was no deterioration in their risk profile.

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

CNB response:
We prefer a sequenced implementation of the measures proposed in the consultation document. If the concept of TELP is adopted, in our opinion a date should be set on which the question of whether a turn in the economic cycle took place is evaluated, whereby the increased provisioning by institutions would be justified and would not disproportionately burdened institutions.

We agree that higher capital requirements for residential mortgages denominated in a foreign currency loans should apply to loans provided after the amendment of CRD IV comes into effect.

1. Through-the Cycle Expected Loss Provisioning (Dynamic Provisioning)

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

CNB response:
We believe discussion of TELP is premature (see general response above). Consultative material should first answer the question of whether the implementation of TELP is the optimal solution. If the answer to this question is affirmative, we believe that this measure could only work if the amended CRD would not contravene accounting principles, which institutions must also observe pursuant to relevant European regulation[3]. The preamble to this regulation states, among other things: "In order to contribute to the better functioning of the internal market, publicly traded companies must be required to apply a single set of high quality international accounting standards for the preparation of their consolidated financial statements.... A proper and rigorous enforcement regime is key to underpinning investors' confidence in financial markets."

The sentence which the Commission proposes adding to Article 57 of the CRD stating that TELP will not be included in regulatory capital is unclear. We point out that Article 74a (4) only speaks of the difference in TELP values for the year ended and the previous year. What's more, if the intent is to prevent the inclusion of created TELP (i.e. their status at the end of the year) in regulatory capital because their creation is reflected in the profit and loss, it is not appropriate to include this sentence in Article 57 of the CRD. We believe it should be included in Article 63 of the CRD, which specifies other items that can be part of capital pursuant to Article 57 of the CRD.

By retaining the sentence in Article 57 of the CRD, it is not clear whether the impact of creating TELP reflected in accounting capital would vicariously affect regulatory capital, or, whether profit for regulatory purposes, and thereby regulatory capital, would be adjusted retrospectively by TELP in the same way as gains or losses arising from the valuation of institution liabilities at fair value, in relation to changes in its own credit risk pursuant to Article 64 (4).

[3] Regulation (EC) No. 1606/2002 of the European Parliament and of the Council, on the application of international accounting standards

Prior to the implementation of TELP it is essential, in the case of IRB institutions, to resolve the matter of how the current test of expected loss coverage by accounting provisions will be conducted and how this will be affected by the creation of TELP. It must be said, however, that expected losses determined by IRB institutions should already be, to a certain degree, "through the cycle", especially in the LGD (loss given default) parameter. The method of calculating the PD (probability of default) parameter is not firmly set. The regulation would therefore have to explicitly require PD to be calculated "through the cycle". The value of the expected loss calculated this way would therefore approximate TELP.

A completely different approach could be a mere regulatory solution that does not affect accounting. This would involve the application of a similar test to that applied by IRB institutions today, i.e. comparing the expected loss with actually created provisions and deducting the potential shortfall from regulatory capital or adding any potential surplus. It would only be appropriate to add this test at credit institutions using a standardised approach, where this test is currently lacking.

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).)

CNB response:
If TELP were to complement accounting provisions and affect profit and loss, it would be more appropriate to refrain from setting TELP for other types of exposures than those for which accounting provisions are set (currently only balance-sheet exposures). If TELP were to operate as a regulatory concept, off-balance sheet items could be included. In this case, this would be analogous to expected losses on exposures at IRB institutions.

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)?

CNB response:
We believe it is entirely inappropriate to implement another concept for internal methods to calculate TELP. If considering improvement of the regulatory concept TELP, it would be more appropriate to proceed from the already introduced IRB regulatory approach and perhaps require institutions that have already been approved this approach to calculate more conservative *through-the-cycle* expected losses (see also Q4) on this basis (with a certain amendment of risk parameters).

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).)

CNB response:
If TELP were only applied to institutions using the standardised approach (see one of the possibilities ad Q 4), then exposure classes should be identical to the standardised approach. In the opposite case, two options can basically be chosen, i.e. either to map from the standardised approach to less numerous exposure classes according to IRB, or, to determine coefficients for exposure classes according to the standardised approach and exposure classes according to the IRB approach separately. However, it is clear that the latter of these options would mean higher costs not just for supervisory authorities, which would determine coefficients, but also for institutions. We would consider CEBS support useful, so that uniform mapping of exposure classes is used in the future.

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

1) the Spanish model of through-the-cycle expected loss provisioning;
2) a 'simplified' Spanish model.

In particular, we would welcome views on the relative merits of both options in terms of the building up of provisions in a graduated manner over time (See ANNEX 1, suggested Annex IXb).

CNB response:
We believe that if the TELP concept is accepted, it should be as simple and comprehensible as possible. The first, more complex model also places greater demands on data and not inconsiderable demands on supervisory authorities, both in terms of determining relevant coefficients and subsequent monitoring of their compliance. For this reason, the second option seems more appropriate. In the second approach, it is also clearly defined that TELP would be determined for all relevant exposures, which corresponds to the usual understanding of this concept (including the Spanish model); while in the first approach it would only be set for exposures that are not in default.

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.)

CNB response:
It is our view that we should utilise current regulation as much as possible and not introduce new risk categories. Using credit quality steps *(CQS)* therefore appears logical. If TELP were also to be set for IRB institutions, their exposures would need to be mapped into CQS. Given that each exposure has a certain risk weight even in the IRB approach, this should not pose particular problems. However, certain risk weight ranges (not just point values) would need to be set for CQS.

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.)

CNB response:
Setting coefficients for the calculation of TELP according to the debtor's location appears more logical than setting coefficients according to the country in which the exposure is booked. The question is whether to proceed according to the debtor's actual place of business rather than the location of the debtor's head office.

In this context, we would like to point out that different coefficient settings in different countries could imply regulatory arbitrage, which could particularly be used in the case of multinational corporations.

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

CNB response:
CNB does not currently have data on losses from individual loans in a historical time series (covering the full economic cycle) segmented according to exposure classes and risk weights, as considered in the Commission proposal. In the initial period, estimates would have to be used to determine counter-cyclical factors and for continual determination standard reporting of data by regulated entities would have to be implemented as data source..

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

CNB response:
We agree that if TELP is applied, it must be set at all levels, not just individual and consolidated, but also sub-consolidated. Article 73, referred to here, imposes this obligation at sub-consolidated level.

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).)

CNB response:
We have no comments on the proposed scope of disclosure requirements for TELP.

2. Specific Incremental Capital Requirements for Residential Mortgages Denominated in a Foreign Currency

Question 14: Do you consider that the risk weights suggested will be effective in discouraging unsafe practices and irresponsible lending in foreign currency denominated housing loans?

CNB response:
We understand that mortgage loans denominated in foreign currencies to households have brought various problems. The question is whether the proposed risk weights are not too high, if we consider that, according to the current wording of the CRD, the highest applicable risk weight for an exposure that is not in default in the IRB approach (apart from securitisation) is significantly lower (375 %). We also believe that an integral part of exercising supervision over institutions is to consistently require the application of prudential approaches, which cannot be replaced by excessive risk weights, despite their discouraging effect.

In order to ensure the real effectiveness of the presented concept, i.e. significant reduction in the provision of these loans, it would be appropriate to resolve the process of allocation to exposure classes, in order to avoid regulatory arbitrage by, for example, an institution carrying a whole exposure as uncollateralised for the purposes of regulation, i.e. allocating it to a class according to the debtor to avoid penalisation.

Question 15: Do you consider a loan to value ratio of 50% or less is sufficient objective evidence that the borrower has sufficient private wealth to withstand currency movements and potentially correlated movements in property prices?

CNB response:
In view of the fact that residential mortgages denominated in a foreign currency are rarely provided in the Czech Republic, we do not have sufficient information to assess the usual degree of loss for this type of exposure and whether 50% LTV is sufficient.

With regard to LTV for mortgages in general, it is unclear how the required figure in the current directive and the currently proposed reduction were determined. Nevertheless, in accordance with the current proposal for exposures collateralised by residential or commercial real estate property denominated in domestic currency, we would like consideration to be given to the harmonisation/unification of regulatory limits and application of a 35% risk weight to just 40% of the market value of the property. Another alternative would be to retain maximum LTV for 35% risk weight at 50% for mortgages in domestic currency, as stipulated for commercial mortgages in the current wording of the CRD.

3. Maximum Harmonisation and Removal of National Options and Discretions

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

CNB response:
In general, we agree with maximum harmonisation in areas that are not based on specific risk assessment, such as Pillar 2.

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

CNB response:
We understand the objective of tightening conditions for the application of preferential risk weights on loans collateralised by real estate property. However, we are of the opinion that an impact study must be conducted to ensure that regulation does not have an undesirable affect not only on institutions, but also on the economy. The material contains no reasoning for how the limit of 50% of the market value of property was derived.
To ensure corresponding harmonisation, it is essential to specify a procedure for determining the degree of loss, including determination of the expected frequency of decision reviews, data requirements (how to proceed in the case of insufficient data for the given segment, etc.) and definition of segmentation (by region, type of real estate property, etc). We consider the proposed measure to be complicated and we also draw attention to the administrative costs for regulated entities inflicted by this measure. We are of the opinion that the provision of guidelines by CEBS might be helpful. Therefore, we support the provision of guidelines by CEBS in relation to this matter.

Apart from the standardised approach proposed in point 44a, we would also like consideration to be given to the addition of a reference to CEBS recommendations in Annex VIII, part 1, paragraph 16 (or 19) for the IRB approach.

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

CNB response:
In terms of efforts to harmonise regulations, we agree with the implementation of a single definition of default. We would therefore prefer elimination of the possibility to set the number of days past due in the definition default at more than 90 days.

When deciding on the timeline for the abolition of discretions, we also recommend taking discretions for the standardised approach pursuant Article 154 (1) and for the IRB approach pursuant to Article 154 (7) into account, which are not included in the amendment bill. We therefore assume these will remain without change (i.e. removal of discretion by 31.12.2011). The current amendment bill only mentions discretions for retail exposures and exposures to public sector entities in the IRB approach, where the proposed date for the removal of discretions is by 31.12.2012.

4. Simplification of the Bank Branch Accounts Directive

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?

CNB response:
We have no objections.

III. Other Comments and Views Regarding the Consultation Document

1. On the provisions of Directive 2006/48/EC

1. Through-the-cycle expected loss provisioning

- It is essential to precisely define to what type of exposures TELP calculation will apply. In the introduction, the material speaks of "non-trading book (i.e. banking book) debt securities". However in proposed Article 74a, the reference relates to IRB classes defined in Article 86 (1) a) to d) and f, g). Yet exposure classes listed under g) include so-called other exposures, i.e. exposures which do not have the nature of debt instruments such as tangible assets and inventory.

- It should be clearly defined to which institutions the proposal applies. The introduction to Annex 1 of the proposed amendment of the CRD states: *"...of introducing a methodology that would apply to banks only..."*, whereas in further proposed articles, the bill speaks of credit institutions, see for example, Article 74a, paragraph 1: *"Competent authorities shall require that credit institutions, in accordance with the prudential methodology laid down in Annex IXb make value adjustments and provisions with regard to credit risks over the course of a full economic cycle..."*

- It is assumed that factors will be determined according to the country where the debtor is "located". It is not clear whether this means where the debtor does business or the location of its head office. We are of the opinion that it would be more accurate to refer to the place where the given subject does business.

2. Residential mortgages denominated in foreign currencies

- Annex VI, part 1, point 50a b) – we recommend that either decimal numbers or percentage points are uniformly used in the formula for the calculation of risk weight (in this case, we believe that instead of the number "1", 100% should be used in the formula). To avoid any doubt, we would also like consideration to be given to a more precise definition of the ratio of the value of the exposure to the market value of the property – so-called coefficient "p" (e.g. specification of the exposure value to be used or explicit maximum limit for the risk weight RV_B, which should not, in our opinion, exceed 1250 %, which is also the risk weight applied to the uncollateralised part of this exposure and maximum risk weight applied to securitised exposures. In the final outcome, a risk weight of 1250 % represents a capital requirement of 100% of the value of the given part of the exposure).

- Annex VI, part 1, point 50b – we propose indicating the effective date of the proposed measure in a separate provision of Article 154.

3. Other provisions

- Annex VII, part 2, paragraph 5 and 20 – we would like to point out the inconsistent formulation of these two paragraphs. We see no reason for the retention of differences and therefore recommend using the same formulation as used in paragraph 5 for corporate exposures, exposures to institutions and exposures to central governments and central banks in paragraph 20 for retail exposures, in order to set a uniform obligation to publish a list of parties recognisable as eligible credit protection providers other than those stipulated in the directive, without the obligation to also publish the reasons for their inclusion on this list..

- Annex VII, part 2, paragraph 14 – we recommend that the list of short-term exposures given in point 14 also include exposures from repo transactions with the central bank for which CNB used discretion in the current CRD and enabled institutions in the Czech Republic to proceed pursuant to point 14. We consider a change in regulatory regime as unjustified in this case, as there is no change in the assigned risk. In this context, we would like to point out that, in its material, CEBS recommended retaining discretion without including a specific list, in that relevant recommendations should be drawn up with the aim of harmonising supervisory authority practice.

4. Technical comments

- Article 74a (1): ".....at the date of reporting pursuant to ~~a~~**A**rticle 74(2)

- Annex VI, part 1, paragraph 44a: delete the word "residential" from the text, as this also refers to paragraphs 53a and 58, which relate to commercial real estate property

- Annex VIII, part 3, paragraph 75: replace "residential real estate property **of** commercial" with "residential real estate property **or** commercial"

- Annex VIII, part 1, paragraph 28: delete the comma in "The competent authorities shall also recognise as eligible providers of unfunded credit protection~~,~~ other financial institutions"

- Annex IX, part 4, paragraph 53: we feel the sentence does not make sense, and therefore recommend considering revising its wording and amending it, for example, as follows: "For securitisations involving retail exposures, the Supervisory Formula Method **may/shall be implemented** using the simplifications: h=0 and v=0, provided that the institution applies this approach consistently."

- Annex X, part 3, paragraph 11: it is not clear from the last sentence of the paragraph what is to be elaborated by CEBS recommendations. In our opinion the reference to CEBS recommendations in paragraph 11 is not relevant. We therefore recommend its inclusion in another provision of the directive.

- Annex XII, part 2, paragraph 17: "c) the changes in the through-the-cycle ...to the previous ~~reporting period~~ **financial year** for each exposure class"

- Article 144, last paragraph: "The disclosure provided for in the first subparagraph....." – to ensure a uniform supervisory disclosure format, it would be appropriate for this format to be agreed within CEBS.

- Article 150a: the definition of off balance sheet items is not included in the right place. We propose its incorporation in Annex IXb.

2. On the provisions of Directive 2006/49/EC

- Article 33, paragraph 3: with regard to the proposed elimination of the discretion contained in Article 33 (3) of Directive 2006/49/EC, we would like to point out that institutions may come across a situation where the latest market valuation is either not available, or, is considered as probably incorrect based on internal checks, in which case the institution needs to find an alternative method of valuation. We believe institutions should retain this option and it is not clear whether this will be the case following the deletion of Article 33 (3) of Directive 2006/49/EC.