Comments by Hungarian Ministry of Finance on the Public Consultation regarding further possible changes to the Capital Requirements Directive (CRD)

We would like to thank the European Commission for the opportunity to comment on the Consultation Document regarding further possible changes to the Capital Requirements Directive (CRD).

We would like to mention as a general comment that due to the several existing and forthcoming initiatives to amend the CRD it is very difficult to anticipate their aggregate effect to the credit institutions. In our point of view before any strategic decision concerning the CRD it is important to have a comprehensive study on possible effects of the proposed changes. We would support the gradual implementation of the necessary modifications in the CRD, and a strict monitoring phase preceding the potential measures.

In our opinion we should take account of the actual economic and financial situation. We are convinced that the application of strict proposed rules require a very careful assessment of the economic and financial situation in order to minimise the risk of strengthening the pro-cyclical effects. The issue of pro-cyclicality should be given large emphasis.

We would like to emphasize that we do not support the proposed maximum harmonisation.

The Capital Requirement Directive (CRD) in force is based on the 86/635 Banking Accounting Directive, but Commission’s current proposals build on the IFRS rules in more aspects, which could cause confusions in the course of implementation. In our view this contradiction should be handled.

We would like to draw attention to the issue of the definition of capital in case of cooperative banks. The proposal doesn’t handle the specific features of this important sector of the industry. In the different sections we express our solicitude in this respect.

We are on the view that the stricter requirements for credit institutions without any restriction on the activities of the unregulated financial firms may increase the share of the ‘grey zone’ in the credit market.

We will follow the structure of the consultation document according to the seven main areas.

Liquidity standards

In principle we support the planned measures related to the liquidity, but as a general remark we would like to emphasize that the funding structures and the behaviour of the savings in different Member States can be very different depending on a number of various factors, as for example the general economic situation, the financial culture etc. In Hungary the short-term deposits are preferred in contrast to the long-term savings, and so the proposed regulation could cause difficulties. There are moreover some Member States where mandatory uniform quantitative liquidity standards do not exist for market participants and in these countries the introduction of ratios may lead to problems. One major problem is that the basis data are not available for the calculation of the standards in Hungary.

We would like to emphasize the importance of appropriate calibration of the indicators. According to our opinion the proposed measures would prefer long term foreign exchange funding (which also would prefer lending in foreign currencies) as opposed to deposit taking,

The Hungarian authorities tried to estimate the possible effects of the liquidity standards and we stated that

- The net stable funding requirement may have especially negative effects to the Hungarian banking sector, dominated by subsidiaries of foreign (mainly EU) banks. Generally the Hungarian subsidiaries receive support from the parent banks, and this short-term (less then 1 year) financing proved to be stable during the crises and they mean liquid assets as well. According to the proposal these assets could not be taken into account in calculating the liquidity ratios.
- As regards the proposed Liquidity Coverage Requirement we found it to be rather volatile. The cash outflows are calculated under a radical stress scenario, meaning a major problem for banks that have a large deposit stock.
- We propose to accept central bank eligible securities (also those issued by financial institutions) as liquid assets.
- The specific features of cooperative banking structures also have to be taken into consideration here. In case of banks which play an apex bank role in the cooperative structures one possible solution could be to handle funds from cooperative banks as retail deposits. Besides that, the proposal ignores the Article 113. (4) d) of Capital Requirement Directive II that the Member States may fully or partially exempt the following exposures from the application of Article 111(1) in the case of asset items constituting claims on and other exposures, including participations or other kinds of holdings, to regional or central credit institutions with which the credit institution is associated in a network in accordance with legal or statutory provisions and which are responsible, under those provisions, for cash-clearing operations within the network.

We support the symmetrical treatment of intra-group transactions and commitments as opposed to the Commission proposal.

In our point of view banks within one Member State, belonging to the same banking group should have the option to comply with the liquidity ratios on sub-consolidated basis, instead of solo basis.

As for the proposed waiver, it should be exercised with great care and in line with the Commission proposal the supervisory authority of the host Member State should be given the right to decide if the subsidiary could be exempt from individual liquidity requirements.

As regards the supervision of branch liquidity, we do not oppose the Commission proposal that if a harmonised set of liquidity rules is in place in the EU then the responsibility for supervision could be given to the home country supervisory authorities, although we have serious concerns also. The liquidity can change rapidly and a deterioration of the liquidity situation poses systemic risk on markets in the host country. That’s why we can accept the home country supervision of branch liquidity only if these problems are adequately addressed. Nevertheless, host supervisors should have access to information regarding branch liquidity position regardless of the significance of the branch as well as the opportunity of on-site examination and the warning from the home supervisor about the contingent problems should be ensured for the host authority. On the other hand we find really important the close connection between the home and host country supervisory authorities.

Definition of capital

In general, we support the strengthening of the capital base by introducing comprehensive and harmonised qualitative requirements for the eligibility of capital instruments. Furthermore, we agree with the simplification of the capital structure by eliminating the distinction between upper and lower Tier 2 and eliminating Tier 3 capital.

As a general comment we would like to draw the attention to the fact that the proposed changes in several points are based on IFRS concept rather than on commonly used EU accounting standards. Such a situation can cause confusions.

We note that the changes in the definition of capital require the re-calibration of prudential indicators (for example large exposures).

We can not see the reasons of excluding capital surplus form the definition of capital, as it is freely disposable by the bank, without having any risk tied to it.

Minority interests are handled in the proposal in an asymmetric way. We do not support this concept. We prefer including minority interests into capital.

It is important that the new requirements take into account the specificities of different forms of credit institutions e.g. co-operative institutions. It is vital that capital instruments of non joint stock companies with loss absorbency features equivalent to common shares continue to be eligible along the lines of Recital 4 of CRD II. We propose that such instruments be eligible as Core Tier 1 if their redemption is subject to the prior approval by the competent authority (and is only allowed subject to conditions). Otherwise, if these instruments qualify only as Non-Core Tier 1, whereas all prudential filters and deductions are based on Core Tier 1 ratios, a large number of credit institutions will not be able to meet their capital requirements. The proposed approach is also supported by the Draft Implementation Guidelines of CEBS (CP 33) regarding instruments referred to in Article 57(a) of Directive 2006/48/EC.

Regarding the discretionary power of supervisory authorities we are on the view that buybacks and redemptions of capital instruments should be subject to supervisory approval. In case of Non-Core Tier 1 or Tier 2 capital the supervisory authority should be in a position to prescribe the conversion or write-down of principal to enhance the recapitalisation of the institution.

We agree with the general exclusion of commitments by co-operative bank members from the capital base as these instruments have not been paid up and are not capable of absorbing losses.

Leverage ratio

In our view the introduction of the leverage ratio as a prudential limit will result in double limitation (the capital adequacy and the leverage ratio) on bank’s activities whereas only one of the limits can be effective. The use of leverage ratio can be justified only in extreme situations, where high leverage stemming from low risk activity is jeopardising the stability. That’s why we suggest to use the leverage ratio only as a monitoring tool with the power of the supervisory authority to intervene if the extreme level of leverage ratio means a systemic risk.

Tier 1 capital should only be acceptable to be used as the basis for the calculation of the leverage ratio if the requirements for eligible Non-Core Tier 1 elements include the conversion to common shares at a specified trigger point (as laid down in the proposal) to ensure effective loss absorbency.

Regarding the treatment of derivatives we support the option for measuring derivatives at replacement cost calculated using the Mark-to-Market method as specified in the CRD as this approach provides a better assessment of leverage taken by the institution by the derivative position. But as CRD now permits to use the original exposure method also, we think it should be permitted to use it also in calculation of leverage ratio.

Counterparty credit risk

In this section the Commission proposal is based essentially on the application of the IFRS method in the respect of OTC derivatives, which is not introduced in every Member States. The Hungarian accounting system is based on the EU directive, and the national accounting standards shows significant differences to the IFRS method. IFRS are available sometimes only on consolidated level, but we can not require the application of the IFRS from the smaller institutions. The implementation of IFRS would cause several problems and considerable costs, like IT costs as well, and it should be harmonised with the national accounting standards. In our point of view the question of the IFRS should be handle in the accounting directives.

Credit valuation adjustment is a problem mainly in IFRS context. If the institution uses no fair value approach there is no risk associated with the trading portfolio. In case of hedging positions in the banking book there can however be found a type of counterparty risk (if the result of the derivative transactions is registered in the balance sheet. In this case it is important to use a method where the counterparty risk can be calculated.

Countercyclical measures

We agree with the need to introduce countercyclical measures, but in our opinion the Commission's proposal is not clear as regards the content and form of such measures. It is necessary to clarify if a countercyclical global provision covering the credit losses during the crisis should be required (which would necessitate an amendment of the accounting rules rather than CRD) or a capital reserve on the side of capital requirement. We support the approach of the capital requirement method and the consequent treatment of the capital reserve.

According to the proposal in the case of the building up of countercyclical global provision on the accounting side it is to be decided, that the provisioning builds on either of the following methods:

- expected cash-flow method,
- incurred loss method,
- dynamic provisioning,
- IRB expected loss method.

We would like to emphasize the importance of taking the national accounting standards in force as a point of origin, if the Commission would like to realise the proposal according to the accounting standards.

On the side of capital requirement the countercyclical global buffer would be realised in the following two forms:

- as fix target-buffer and
- as through the cycle buffer.

The detailed forming of these rules would be worked out later.

In connection with the abovementioned we are convinced that building countercyclical global buffer both on accounting and capital requirement sides is needless. Only one side should be dealt with and in our opinion capital requirement is the best applicable. Then we could on one hand define all the requirements in the frame of CRD and on the other hand we would not have to pay attention to the forthcoming amendment of IAS 39 and the tied IFRS by IASB, and to the amendments which should be made to the 86/635 Banking Accounting Directive. Building up the countercyclical global buffer parallel on both sides makes accumulation inevitable as – although CRD assumes that the banks in the EU prepare the individual report according to the national accounting rules based on 86/35 Directive but still – in some countries the application of IAS/IFRS rules on the level of individual reports is also allowed the application of non-unitary accounting practice in the EU. The mandatory application of IAS/IFSR for listed parent banks on the level of consolidated report makes it more difficult and raises the question that by forming consolidated capital requirement the differences coming from using other accounting data should be handled.

From the methods of building up the countercyclical global buffer in the form of accounting provision the ECF method and method of incurred loss in IAS 39 standard assume, that the bank keeps its accounting files and makes its report according to the IAS/IFRS rules, but most of the banks in the EU prepare their reports according to the national regulation based on 86/35 Directive, which is also admitted in CRD. With these methods the problem is, that the ECF method is under drawing up and consultation and also the remodification of IAS 39 has not terminated. Consequently we should orientate to a changing basis, and the implantation of certain elements of IAS/IFRS to the present practice would be expensive for the banks applying EU accounting rules.

Concerning the dynamic provision – especially the Spanish example - questions which came up in the previous CRDWG meetings are still open like the double accounting of credit risk provision in the rescheduled periods of the economic recovery.

Building up the countercyclical provision on the IRB expected loss method is problematic because most of the banks use the standard method rather than IRB, so the implantation of certain elements of IAS/IFRS to the present practice would be expensive for the banks. For banks using ab ovo the IRB method provided that the expected loss is built in the capital requirement - not as a countercyclical but as a normal element - it is needless to stipulate as accounting provision titled as countercyclical buffer.

It should be examined whether the „general banking risk provision” laid in 86/635 Directive (Articles 37-38.) can be used for this purpose and if not, what is the relation of this provision to the new global provisions as it is itself a global provision as well. If the creation of a global accounting provision for the credit loss during the crises is necessary, the development of these „general banking risk provision” rules would be suitable.

For the question (Question 38.) how can be the three different methods (ECF, incurred loss method from IAS 39, IRB expected loss method) evaluated based on own experiences Hungary cannot give a definite answer, as none of these were used by the Hungarian banking system in connection with the accounting provision. The Hungarian banking accounting regulation is based on the 86/635 and the 78/660 4. Directive, so provisions should be kept for losses to be expected in the future coming from incurred economic events known till the accounting day. Besides that, the system of generating the general bank risk fund (according to the domestic regulation „general risk provisions") according to the Directive 86/635/EGK can be used for the aim of covering the unpredictable deficit. In our opinion, this regulation established an adequate cover in the Hungarian banking system from 2000 till nowadays, because serious bankruptcy did not emerge during this period. It is decisively due to that fact that the domestic regulation demands stricter valuation (reserve and loss of value) rules from the banks in regard to the „special bank risk" than the other companies.

We reserve our opinion we represented before in connection with the global puffers in capital. These are mainly the followings:

We consider that the requirement of the countercyclical surplus should be determined as followings:

- the requirement of the capital surplus should be determined on the bases of a set of indicators representing the economic state of the banking system rather than only by one indicator relating to the whole macro economy, and its measure should be determined in relation to the minimum capital requirements according to the CRD (above the minimum capital requirements per cent)
- built on the above mentioned methodology, the system should work automatically, as far as it is possible, so as to have less opportunity to abuse the rules on the bases of individual decisions,
- we would support the gradual facing in of the increased capital requirement,
- it is important to highlight that the introduction of the rules of the countercyclical surplus capital-requirement could not reduce the activity and business policy of the banks to such an extent that it has contradictory effect to the original target.

If the countercyclical global buffer would be determined on the side of the capital requirement, it is worth considering to build up this buffer in a concrete element of own capital at disposal, which would be controllable and its building up would precede the payment of dividend, redemption of the shares and the payment of the benefit like allowance from profit after taxes. The separated provision within the own capital would be the most adaptable, which should build up according to a determined method after the payment of dividend, redemption of the shares and the payment of the benefit like allowance from the profit after taxes of given business year. In the Hungarian regulation provision within the own capital exists currently as well, which should be built up from the 10% of the positive profit after taxes of given business year before the payment of dividend and used only then and to that extent if the result of the business year is unprofitable.

In our opinion depending on how the bank meets its requirement the forms of the payment of the dividend and the redemption of the shares should be limited to a reasonable extent.

Systemically important financial institutions

In our opinion it could be risky to determine the list of the systemically important financial institutions, implying moral hazard problems. Otherwise the definition of the scope of the systemically important financial institutions is complicated enough to define due to the differences of the systems, the countries and the time factors. If there is no pre-defined publicly available list of systematically important financial institutions, it is difficult to imagine a capital adequacy regime that takes this factor into consideration.

Single rule book in banking

We do not agree with the Commission's proposal, because the definitions and the proportions are not clear for us and we would support to leave out this section from the CRD.