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CRD IV - Nordic position paper

Introduction

The Nordic banking associations have prepared this joint position paper as a response to the Commission Proposal on CRD IV. We represent the major part of the Nordic banking sector and our cooperation is especially focused on making sure that the Nordic financial market can continue to develop. Since the Nordic market is a highly integrated one, we see a need for more and improved harmonisation of rules, as well as for more cooperation among authorities in the Nordic and European region.

We support the Commission's ambition to harmonise minimum capital requirements for banks across the EU's internal market. Harmonised rules are an important precondition for a well functioning and efficient single market for financial services.

However, in the area of capital requirements, the Proposal contains a number of possibilities for national discretions at the supervisory level that could have harmful effects on the internal market. For example, the Proposal gives national supervisors the possibility to introduce new requirements earlier than foreseen by the phasing-in plan in Basel III, and it widens national supervisors' mandates to set capital surcharges under Pillar II. These options for national and supervisory flexibility are examples of features that may lead to legal uncertainty for institutions, may distort competition, and may create opportunities for regulatory arbitrage, while having very uncertain beneficial effects, if any, on financial stability.

The proposed regulatory framework for liquidity risk allows for the possibility to consider covered bonds as assets that are of extremely high liquidity and credit quality – an approach that we support strongly against the background of the well functioning, highly liquid covered bond markets in e.g. Denmark and Sweden. Current conditions on the European financial markets justify broadening the eligible assets in the LCR buffer even further to include *all* central bank eligible assets. We also support the approach of open-mindedness in the analysis of the consequences of introducing the NSFR. In our view, consideration should be given to how the measure should be used, whether the calibration of the ratio could be altered, and if NSFR could possibly be replaced with an alternative metric.

Furthermore, we question whether the proposed cap on inflows at 75 percent of outflows is justified. The 75 percent cap will artificially magnify the funding requirements. We also question the stricter currency restrictions in CRD IV

compared to Basel, since they will create considerable difficulties for credit institutions in smaller, open economies outside the euro-zone.

Capital

Transitional provisions

Early implementation of Basel III minimum capital requirements (Articles 448-450, 458-461 and 464 of the Regulation)

The possibility for national supervisory authorities to require banks to live up to Basel III end levels already from 1 January 2013 could distort the level playing field across EU member states during the transitional period. Besides demanding higher minimum capital levels, supervisory authorities also get the option to demand faster phasing out of capital instruments that have previously qualified to meet capital requirements. If it is used, the latter could create a situation where many institutions have to issue certain instruments within a short period of time, possibly under unfavourable market conditions. Our view is that if the possibility remains to implement Basel III minimum capital end levels faster than set out in Basel III, a sufficient phasing out period of non-qualifying capital instruments must be secured.

The extension of Basel I floors (Articles 441 and 476 of the Regulation)

In addition to the possibility for early implementation of Basel III, the Basel I floors have been extended, with a possibility to waive the floor requirements only at the national supervisory level and subject to strict conditions. In our view the use of Basel I requirements creates wrong incentives since they are not risk-sensitive. As a result, the floor would punish low risk banks while providing incentives for risk-taking.

Furthermore, banks currently applying the standardised approach would receive an incentive not to switch to the IRB model, since the risk weight for residential loans would then increase. In addition to this, the calculation of the floors according to Annex IV differs from the way Basel I has been implemented in various Member States. Banks would have to re-adapt their systems to the calculation method proposed in Annex IV, meaning an unnecessary increase in administrative costs.

Finally, national supervisors already have appropriate tools to safeguard capital levels, if they fear that banks will release too much capital during the phasing-in period proposed in Basel III. We therefore propose that the prolongation of the Basel 1 floor is deleted.

The cut-off date for grandfathering of own funds instruments (Article 463 of the Regulation)

The Commission proposes that only instruments issued prior to 20 July 2011 will qualify for grandfathering. As a result instruments issued thereafter that do not meet the new conditions will be removed (or downgraded) from the classified own funds from 1 January 2013. Since the final provisions and the treatment of many instruments under the new CRD IV regime is still open, the proposed date for grandfathering would disincentivise banks from strengthening their capital base by issuing new instruments before entry into force of the new regime. Moreover, retrospective legislation is not in line with the general principles of the EU legal system. For the above mentioned reason, we suggest changing the cut-off date for grandfathering from 20 July 2011 to 1 January 2013.

The mandate to the Commission to set stricter rules for a limited period of time (Article 443 of the Regulation)

The proposal allows the Commission to adopt by means of Urgency procedure (see Article 446) a temporary increase in prudential requirements where this is necessary to address changes in the intensity of micro-prudential and macro-prudential risks which arise from market developments. However, the Regulation Proposal already provides a range of new measures (including two additional capital buffers) to address changes in micro- and macro-prudential risk arising from market developments. Therefore, we find the proposed mandate to the Commission to act as a European macro-supervisory authority unnecessary.

Pillar II (Articles 92, 94 and 95 of the Directive)

In the proposal, the mandate for supervisors is substantially widened compared to the current legislation through the introduction of several new features. One is the introduction of systemic risk as a basis for capital surcharges (Article 92). Another is the introduction of a possibility to set a capital surcharge on certain types of institutions that are or might be exposed to similar risks or pose similar risks to the financial system (Article 95). Finally, the technical criteria for capital surcharges are extended, including e.g. geographical location of exposures, a bank's business model, corporate culture and values and excessive leverage (Article 94).

In our view, the provisions in the above mentioned articles should be designed in a way that secures harmonised implementation of the Pillar II process for capital surcharges across the EU, bearing in mind that Pillar II should continue to be focused on an individual bank basis. Predictability and transparency for institutions and avoiding regulatory arbitrage between countries must be a high priority. We are also of the opinion that EBA has a crucial role to play to secure uniform application

across the EU of the technical criteria, as well as improving transparency in the Pillar II process.

Other issues on capital

Leverage ratio (Articles 416, 417, 482 and Recital 68 of the Regulation,)

The leverage ratio measure does not take into account the risk profile of an institution's business. The Basel Committee's rationale for introducing a non-risk-weighted measure was to complement minimum capital in relation to risk-weighted assets. However the measure punishes institutions that, under normal conditions, would be assessed to have a lower risk in their business model, such as certain types of mortgage institutions, as compared to institutions with a higher risk profile. We fear that it will lead to increased securitization of banks' mortgage loan portfolios, with less market transparency and a potential build-up of higher systemic risks as a consequence.

A compromise in the Basel III agreement was to use an observation period for further analysis before deciding whether, and if so how, to introduce the ratio. We suggest that the ambition stated in Recital 68 to the Regulation that the ratio should be introduced as a strict rule, should be deleted, in order to secure an "open-minded" approach to the measure.

Stricter requirements on large exposures (Article 4, no 25, and Article 384 of the Regulation)

A new capital base, "eligible capital", is introduced for large exposure rules, setting a cap on Tier 2 capital of 25 percent of total eligible capital. As the current CRD framework permits Tier 2 capital to be included up to 50 percent of the total capital base used for large exposure calculation, the new rule would effectively lead to a stricter large exposures regime. This part of the proposal does not seem to correspond to Basel III nor to single rule book considerations.

In our opinion, any future tightening of large exposure limits should be subject to an impact analysis before it is introduced in regulation. In the mean time the capital base should be as closely aligned as possible to current rules. We therefore propose that the cap on Tier 2 capital is changed to 50 percent of the total capital base for the purpose of large exposure calculations.

Excluding additional Tier 1 capital instruments with dividend stoppers (Article 50 of the Regulation)

Article 50 prohibits institutions from setting a condition in the terms of Additional Tier 1 capital instruments, that dividend payments on core equity shall be cancelled if interest is not paid on Additional Tier 1 instruments, so called dividend stoppers.

In our opinion, however, dividend stoppers are important to preserve the order of ranking between holders of Additional Tier 1 instruments and common shareholders. Excluding such features would, in our view, make it very difficult to issue additional Tier 1 instruments and it would diminish the possibility to acquire loss-absorbing institutions from setting a condition in the terms of an Additional Tier 1 instrument, that dividend payments on core equity Tier 1 capital shall be cancelled if interest is not paid on the Additional Tier 1 instrument.

LGD floors on real estate loans (Article 160(4) of the Regulation)

The Commission proposes permanent LGD floors on residential real estate loans (10%) and commercial real estate loans (15%). We believe that this approach is against the aim of a more risk-sensitive regulatory framework and gives rise to a disincentive for banks to invest in and develop IRB models. It would also question the reliability of banks' own LGD estimates and could decrease the supervisor's incentive to monitor IRB models. In certain Nordic countries historical loss data even in the severe banking crisis in the early 1990's does not justify these LGD floor levels. The proposed LGD floors should therefore be removed. Given the differences in the mortgage markets in Europe, national authorities should have the possibility to set LGD floors in their jurisdiction if they can justify this based on the loss data collected from their banks under Article 96.

Treatment of certain capital instruments (Article 26 of the Regulation)

We are generally concerned that the proposed definition of CET 1 capital is too narrow. The Commission Proposal categorically states that CET 1 instruments according to Article 26 cannot have preferential treatment compared to other CET 1 instruments that fall within the scope of this Article, either when it comes to distributions or loss sharing. Even though the Proposal lacks an explicit definition of preferential distribution, we believe that the current wording excludes instruments that are of vital importance for a number of institutions. First, our concern relates to the treatment of different classes of ordinary shares containing provisions to pay higher dividends to compensate for lower voting rights. These types of shares should not be confused with preference shares specifically regulated in the general company legislation in many countries. Second, the different types of common equity

are used by institutions whose legal form is different from that of joint-stock companies. We cannot see that the special provisions on capital instruments of/ issued by “mutuals, cooperative societies and similar institutions” (Article 25 and 27), gives the necessary waivers, as they both require that the conditions laid down in Article 26 are to be met.

The instruments described above are commonly used in the Nordic countries and have similar loss-absorption capacity, non-cumulative dividend rights and shareholder ranking priority in the insolvency proceeding as other CET 1 instruments. Against this background, they should be eligible as CET 1 capital.

Continue the current treatment of intra-group holdings in financial conglomerates (Article 46 of the Regulation)

We welcome the treatment of investments in insurance companies according to the current CRD regime. We find this justified since financial conglomerates are subject to harmonised regulation and supervision in Europe (unlike globally). Basel III is, therefore, not an appropriate reference when deciding on the treatment of such intra-group exposures in the EU. Financial conglomerates play an important role in the financial market of Nordic countries and have proved to be stable even in distressed situations. It is therefore important that the current Articles 59 and 60 of the CRD are transposed into the new EU legislation. Furthermore, it is important that the possibility to apply these articles is introduced as a choice for a credit institution in the Regulation Proposal, and not in the form of a national discretion for supervisors.

Liquidity

The inclusion of covered bonds in the liquidity buffer as instruments with “extremely high liquidity” (Article 404 of the Regulation)

We find it very important that the definition of liquid assets in CRD IV, compared to the definition in Basel III, is broadened to enable diversification and avoid concentration on European sovereign debt.

We therefore support the fact that the regulatory framework for liquidity in the CRD IV Proposal takes into account the specific market conditions in Europe and allows for the possibility of considering covered bonds as assets that are of extremely high liquidity and credit quality. It is crucial that this possibility is kept in the final regulation.

The scope of the delegation to the Commission and EBA on LCR (Article 444 of the Regulation)

In CRD IV (Article 444) the Commission has the power to adopt a delegated act to specify in detail the general requirement for the liquidity coverage ratio (LCR) (Article 401). The Commission also has the power to modify the items to be reported under the proposed provisions on liquidity reporting (Title II, Liquidity reporting). We do not consider it appropriate to delegate such powers to the Commission without adequate means for the Member States to influence such an important area of financial regulation. Delegation of powers should be reserved for supplementing or amending certain non-essential elements of legislative acts.

The requirement concerning the liquidity coverage ratio, and the possible need for modifications of the items to be reported, are essential issues which potentially can have a material detrimental impact on businesses and financial markets.

Such important issues should be subject to the ordinary legislative procedure in the Council and the European Parliament. It also needs to be underlined that any future legislation in this area should be preceded by a thorough reporting and monitoring exercise.

The cap on inflows to 75 percent of outflows (Article 413 of the Regulation)

In CRD IV the liquidity needed in the stressed scenario is not calculated as the difference between inflows and outflows. Irrespectively of the actual difference between the stressed inflows and outflows, the stressed inflows are capped at 75 percent of the stressed outflows. This cap is not justified and will artificially magnify the funding requirements, without any real rationale.

The cap on inflow will indeed punish a bank or a mortgage credit institution whose stressed cash inflows exceed 75% of stressed cash outflows. This would mean that there is a disincentive to reduce the liquidity risk by eliminating the net outflows by match-funding (pass through) as done by some mortgage credit institutions, since liquid assets would need to be acquired anyway in order to meet the liquidity buffer requirement even though the actual liquidity risk is very low.

The cap on inflows should therefore be deleted since it is very punitive for a stable system based on matched funding with low liquidity risk and it will not give the incentives to reduce liquidity risk.

Currency restrictions (Article 405 of the Regulation)

The CRD IV Proposal requires that denomination of liquid assets is consistent with the distribution by currency of liquidity outflows after deductions of capped inflows.

This provision is considerably stricter than Basel III, which only requires that LCR shall be calculated in the domestic currency after taking account of hedging foreign exchange risk. The CRD IV provision will create considerable difficulties for credit institutions in smaller, open economies outside the euro-zone. We therefore strongly oppose the stricter currency restrictions in CRD IV compared to Basel III.

Outflow on corporate deposits (article 410 of the Regulation)

The assumption of 75 percent runoff of corporate deposits within 30 days is in our view far too severe, and not based on empirical evidence. The assumption needs to be reviewed during the observation period.

Treatment of central bank eligible assets (Article 404 of the Regulation)

We find that the current conditions on the European financial markets justify that the eligible assets in the LCR buffer should include all central bank eligible assets. A narrow definition of liquid assets, that would exclude central bank eligible assets per se, as proposed in Basel III, can create a substantial systemic risk for the banking industry at the very same time as regulators are trying to mitigate systemic risk because all banks will be exposed to the same narrow group of liquid assets.

Net Stable Funding Ratio (Article 414 of the Regulation)

We appreciate that the Net Stable Funding Ratio has not been introduced as a binding standard in the CRD IV proposal. The Net Stable Funding Ratio, as defined in Basel III, does not appropriately take into account the important and crucial role for banks to perform maturity transformation. More specifically the Basel proposal does not appropriately take into account the aspect of for example mortgage credit systems which rely on "pass through" funding. This would have a damaging effect on an otherwise well functioning system. We therefore wish to stress the importance of a thorough analysis concerning a future Net Stable Funding Ratio in order to ensure that such as measure will be tailored to take into account specific conditions in Europe.

General and procedural issues

The role of EBA

In order to ensure consistent harmonisation, EBA is entrusted to draft and propose binding or regulatory technical standards or guidelines. Before submitting such technical standards or guidelines to the Commission, EBA shall conduct open public consultations with sufficiently long comment periods and undertake analysis of the proposals, unless this is disproportionate in relation to the scope and impact of the standards concerned *or in relation to the particular urgency of the matter*. EBA shall also request the opinion of the Banking Stakeholder Group unless actions must be taken urgently and consultation becomes impossible. If EBA does not submit the draft standards within the time limits, the Commission may adopt an implementing technical standard by means of an implementing act.

The Nordic Banking Industry is concerned over the large number of proposed technical standards and guidelines which will require significant work by EBA. Given the required strict time limits to prepare standards we see a danger that several of the consultations will not be carried out and that decisions will be made by the Commission in the form of urgency procedures. It is important that consultations are made to ensure quality and that national specificities are taken into account.

Delegated acts

The Commission proposes that it should be delegated powers to make final decisions on regulations in several important and broad areas, justified among other reasons by the need to respond to developments in financial markets, effects of inflation, micro-prudential and macro-prudential requirements.

Delegation of powers on important political issues with clear effects on the activity in institutions, as well as in the general economy, must be supplemented by standard procedures for consultations and decisions. If not, the delegation will lead to less transparency and a less predictable environment for economic activity. The need for proper consultations should be specified in a recital.

Corporate governance (Articles 86 and 87 of the Directive)

Detailed binding corporate governance rules should be avoided since the organizational structure of institutions varies significantly depending on the size and nature of their business and the legal form. Furthermore, the legal basis for corporate governance models varies substantially across EU Member States. In the Nordic Countries there are well functioning models of corporate governance in place, based on company law and well developed codes of conduct. We propose that the

rules in the Directive are kept at principle level, in order to allow for already well functioning corporate governance structures based on national company law to be kept at the national level, at the same time living up to high-standard harmonised principles in the directive. Furthermore, if these provisions go too much into detail, we risk creating a specific set of rules equivalent to national company law, applying only to financial institutions in the EU. This could lead to a harmonisation of EU company law “through the back door”. We believe that CRD IV is an inappropriate tool in this regard.

Sanctions and subsidiarity

Article 5 in the Treaty of the European Union (TFEU) lays down the principle of subsidiarity. In the Commission’s Proposal for a Directive it is indicated that the provisions of the Proposal do not go beyond what is necessary to achieve the objectives pursued. In our view this statement is too general and we have considerable concern whether the provisions set out in Article 65-71 concerning administrative pecuniary sanctions meet the requirements of the principle of subsidiarity. In particular we are concerned about the power delegated to EBA in Article 69 (2) to issue guidelines addressed to competent authorities on types of sanctions and the level of administrative pecuniary sanctions.

In our view setting the level of administrative pecuniary sanctions should be left to national authorities and courts. It is a fundamental principle that the courts are free in setting pecuniary sanctions, within the framework of the law and according to case law.

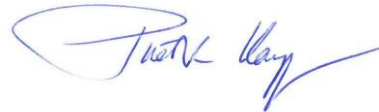
Another problem of concern is that the setting of the level of pecuniary sanctions is delegated to EBA, which is comprised of national supervisory authorities acting without superior political guidance and control.

The objective of the Commission’s Proposal is to harmonise sanctions between Member States because divergences exist in different Member States in the level of application of sanctions. This is, of course, a creditable objective, but the level of sanctions in concrete situations should also be seen in the light of additional penalty measures to ensure compliance with the banking legislation, first and foremost disclosure of supervisory reports and injunctions on the website of the bank in question.

Even though the guidelines issued by EBA may not be legally binding, it is inevitable that the guidelines will have a major influence on the decisions of the courts in specific cases.



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