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Response to the Danish Financial Supervisory Authority's consultation of the EU Special Committee for the Financial Sector on the Commission's proposal for a review of the CRR, CRD IV, BRRD and SRMR

With a view to preparing a background and subsidiarity memorandum, the Danish Financial Supervisory Authority is soliciting comments on the European Commission's proposals to amend the Capital Requirements Regulation, CRR, the Capital Requirements Directive, CRD, the Bank Recovery and Resolution Directive, BRRD, and the Single Resolution Mechanism Regulation, SRMR.

Danmarks Nationalbank welcomes the proposals from the European Commission. This package of proposals introduces a number of important and useful new international standards (cf. the Basel Committee) for requirements regarding credit institutions' leverage, liquidity, coverage of market risk and large exposures in EU legislation. In addition, special new requirements are proposed for global systemically important credit institutions. All in all, these proposals constitute an important element of the efforts to learn from the financial crisis and strengthen the regulatory framework in order to reduce the risk of future financial crises.

In general, Danmarks Nationalbank is of the opinion that it is in the interests of Denmark to have international financial rules that ensure uniform framework conditions across countries and credit institutions. As regards Danish credit institutions, it will also support confidence in the institutions if they observe international standards without any special Danish rules.

Danmarks Nationalbank has the following more specific comments, which will be elaborated on below:

- *Total loss-absorbing capacity, TLAC, and minimum requirement for own funds and eligible liabilities, MREL:* Danmarks Nationalbank does not find that the MREL exemption can be applied to mortgage banks and

recommends that mortgage banks be comprised by the same rules on resolution as other institutions. Danmarks Nationalbank supports the proposal to integrate the TLAC into the MREL system.

- *Net stable funding ratio, NSFR:* As a source of funding, short-term mortgage bonds, which in Denmark are subject to the act on maturity extension, and which are used for funding loans with longer maturities, should not be regarded as being just as stable as long-term bonds. Danmarks Nationalbank finds that only bonds with the same maturity as the loan should be regarded as "interdependent".
- *Market risk:* An effort should be made to ensure that the Danish fixed exchange rate policy is more clearly reflected in the capital requirement for exchange rate risk under the standardised approach, and that the Danish krone is included among the "most liquid currencies" when determining the liquidity horizon for interest rate risk for institutions applying internal models.
- *IFRS 9*: The wording of any transitional provision in the CRR should await the final guidelines from the Basel Committee in this respect.
- *Risk weights for small and medium-sized enterprises, SMEs*: The proposal to retain the supporting factor arrangement for exposures vis-à-vis SMEs should be rejected.

TLAC and MREL (CRR Art. 72a-72l, 92a and other articles, and proposal to amend the BRRD)

The Commission has presented a proposal to amend the Bank Recovery and Resolution Directive (the proposal) that implements elements of total loss-absorbing capacity, TLAC, taking into account the existing provisions on "minimum requirement for own funds and eligible liabilities", MREL.

The basic aim of the Bank Recovery and Resolution Directive, BRRD, is to safeguard the interests of the economy in general, including financial stability. The fundamental principle behind the resolution regime is that the losses of a failing institution should, first and foremost, be borne by the owners and creditors.

Danmarks Nationalbank finds that this is a good and sound principle: It should be possible to resolve any institution without major negative consequences for the economy and financial stability – and without the use of taxpayers' money.

The Danish mortgage credit system has a special position in the Danish financial system due to its significance to lending and the credit institutions' use of mortgage bonds for liquidity management. It is of paramount importance that it is possible to resolve mortgage banks

without systemic consequences, taking into account the resolution objectives to be met when deciding on resolution measures for, inter alia, mortgage banks.

The proposal envisages retaining the existing MREL exemption for mortgage banks, cf. Art. 45a of the proposal. The consequence of this exemption is that we give up some of the central resolution options under the BRRD. The exemption is conditional upon an assessment that other resolution options and the liquidation model in the Danish Mortgage Credit Act will, jointly or separately, meet the resolution objectives. In the opinion of Danmarks Nationalbank, there are relevant scenarios where that assessment is not correct.

A consequence of the MREL exemption is that when a loss in a mortgage bank is to be absorbed, there will not be many eligible liabilities present. If a mortgage bank's loss exceeds 2 per cent of its lending (the debt buffer), it is the assessment of Danmarks Nationalbank that the prerequisites for the exemption are no longer met.

This is particularly because it would have unacceptably large knock-on effects on the economy, including financial stability, if a mortgage bank were to be resolved in accordance with the liquidation model that would be the prescribed "national insolvency procedure" for a Danish mortgage bank, cf. the reference in BRRD Art. 45(3)(b).

The liquidation model for mortgage banks entails that the mortgage bank's lending is discontinued in a controlled manner as loans are gradually repaid. The mortgage bank will no longer issue new loans. Due to the size of the mortgage banks, this will mean that the financial sector's total capacity to grant loans becomes insufficient.

In addition, the mortgage bond owners will suffer losses in connection with the liquidation. That will be the case even if there are sufficient funds to ensure that investors get back their money after the liquidation. The losses will come in the form of late payments, lower prices and reduced liquidity in the bonds. The banks own a considerable share of the mortgage bonds. For them, it will have huge consequences if they suffer losses on these bonds. It will increase their required capitalisation in a situation where their capital is already under pressure.

Losses on mortgage bonds will affect confidence in the mortgage credit system overall, and the other mortgage banks will have difficulty in obtaining funding because their risks are very similar.

On the basis of the above, it is Danmarks Nationalbank's clear recommendation that mortgage banks be comprised by the same rules on resolution as other institutions. In the assessment of Danmarks Nationalbank, the costs to borrowers of implementing these rules will be small, while the advantages of having a resolution mechanism which ensures resolution of a mortgage bank without major negative consequences for the economy and financial stability – and without use of taxpayers' money – will far exceed these costs.

Net stable funding ratio, NSFR (CRR new Title IV, Art. 428a-428ag)
With the proposal from the European Commission, the Basel standard for requirements for stable funding will be incorporated in the CRR. Credit institutions are to maintain a net stable funding ratio, NSFR, of at least 100 per cent. The NSFR is defined as "available stable funding" divided by "required stable funding". The basic objective of the requirement and the methodology included in the provisions on calculation of the NSFR is that the institutions should always have funding available for their activities 1 year ahead.

Danmarks Nationalbank finds that, with the NSFR, an international standard has been developed that solves a major problem from the financial crisis. The requirement to observe the NSFR will encourage institutions to ensure that they continuously have stable and, from a maturity perspective, sufficient funding for their assets.

In accordance with the Basel standard, the proposal allows the national supervisory authorities to determine that certain assets and liabilities are "interdependent" (Art. 428f) and "net out" (i.e. are in effect exempted) in connection with calculation of the NSFR. Among other requirements, the maturities of the assets and liabilities in question must be the same.

As a derogation from the Basel standard, it is proposed in Art. 428f(2)(d) that bond issues with maturity extension triggers may also be regarded as interdependent with loans, even if the loan and the bond issued have different maturities. Danmarks Nationalbank does not support this derogation from the Basel standard. Only bonds with the same maturity as the loan should be regarded as "interdependent".

In Denmark, the act on maturity extension is meant to be a "back stop" in the specific situation where an auction of short-term mortgage bonds fails, or in connection with very large, sudden interest rate increases. Observance of the NSFR without exemption of bonds subject to the act on maturity extension will contribute to boosting confidence in the mortgage banks' business model and ensuring a stable funding structure

within the mortgage banks. It is important that the mortgage banks observe an internationally acknowledged key ratio such as the NSFR without special exemptions.

Market risk (CRR Art. 325 – 325bq)
The proposal implements the new Basel standard for market risk. The proposal lays down new criteria for the distinction between "trading book" and "banking book", new requirements for institutions applying internal models for calculation of the regulatory capital requirement for market risk and a new standardised approach for market risk.

As regards the rules on use of *internal models*, Danmarks Nationalbank finds it positive that Art. 325be(5) specifies that currency pairs consisting of the euro and the currency of a member state participating in the second stage of economic and monetary union are to be included in the subcategory "most liquid currency pairs" when determining liquidity horizons for foreign exchange risk. This provision seems to include euro/Danish kroner.

According to Art. 325be(7)(b) of the proposal, the European Banking Authority, EBA, is to prepare a draft for a regulatory technical standard specifying, inter alia, the currencies included in the subcategory "most liquid currencies" when determining liquidity horizons for interest rate risk. Danmarks Nationalbank recommends that the Danish Financial Supervisory Authority, through its participation in the EBA, works to ensure that the Danish krone is also included in this subcategory.

As regards the rules for the new *standardised approach* to market risk, Danmarks Nationalbank finds it positive that the capital requirement for credit spread risk for covered bonds issued by credit institutions in the EU is to be calculated on the basis of a widening of the spread by 200 basis points, cf. Art. 325ai of the proposal, while the Basel standard prescribes that sensitivity must be calculated on the basis of a widening of the spread by 400 basis points. 200 basis points is still a large widening of the spread relative to the historical volatility of covered bonds issued by Danish institutions, but not necessarily relative to the volatility of covered bonds issued by institutions in other EU member states. The standardised approach does not envisage further differentiation of credit risk spreads, either in relation to credit risk or the issuer's home country, so it cannot be expected that the standardised approach will reflect the exact conditions in the individual markets. Large institutions that are active in the Danish covered bond market will presumably be able to apply for approval to use internal models, so that

they will be able to calculate their regulatory capital requirements on the basis of empirical data.

According to Art. 324aw(1) of the proposal, the capital requirement for exchange rate risk under the standardised approach should, as a main rule, be calculated on the basis of a 30 per cent change in the exchange rate. But for currency pairs consisting of the euro and the currency of a member state participating in the second stage of economic and monetary union, subarticle (2) of the provision states that the capital requirement must be calculated on the basis of a 30 per cent change in the exchange rate divided by the square root of 2 (corresponding to approximately 21.2 per cent). This exemption seems to be aimed at euro/Danish kroner, but reflects neither historical fluctuations between the euro and the Danish krone nor the formal fluctuation limits in ERM2. Danmarks Nationalbank recommends that Denmark seek to achieve an adjustment of the exemption in Art. 325aw(2) so that the provision is better aligned with the fixed exchange rate policy.

Danmarks Nationalbank is aware that the new standardised approach may entail other challenges for the institutions, e.g. in relation to the use of euro-denominated interest rate derivatives for hedging of interest rate risk in Danish kroner. However, it is not given that interest rates in the two currencies always move in parallel. Danmarks Nationalbank has not had the opportunity to quantify the effects of the individual elements of the proposal but encourages the Danish Financial Supervisory Authority to have a dialogue with the institutions about this issue.

IFRS 9 (CRR Art. 473a)

On 22 November 2016, the European Commission approved the International Financial Reporting Standard IFRS 9, which, inter alia, lays down a new model for calculation of loan impairment charges. The Standard will apply in financial years beginning on 1 January 2018 or later, but earlier application is permitted. The transition to IFRS 9 can be expected to lead to an increase in the level of the credit institutions' accumulated loan impairment charges.

The proposal to amend the CRR, Art. 473a, includes a proposal for a transitional provision, under which institutions may, for a period of 5 years, add a gradually falling share of the expected credit losses calculated according to IFRS 9 to the Common Equity Tier 1 capital. Presumably, this proposal is to be seen as an attempt to avoid sudden drops in the institutions' capital ratios in connection with the transition to IFRS 9.

Danmarks Nationalbank does not understand the rationale behind this proposal. Any transitional arrangement should address only the *change* in the level of the institutions' loan impairment charges as a result of the transition from the existing rules, not the aggregate level of loan impairment charges.

In October 2016, the Basel Committee presented proposals for relevant transitional rules in connection with the transition to IFRS 9. Danmarks Nationalbank finds that the formulation of any transitional provisions in the CRR should await the final guidelines from the Basel Committee.

Risk weights for loans to small and medium-sized enterprises (CRR Art. 501)

The Commission proposes extending the arrangement whereby a discount applies to the risk weights for exposures to small and medium-sized enterprises (SMEs), with the effect that the existing reduction of the capital requirement by 23.81 per cent for SME exposures up to 1.5 million euro is supplemented with a reduction of the capital requirement by 15 per cent for SME exposures exceeding 1.5 million euro (with no upper limit).

The supporting factor applying to the capital requirement for loans to SMEs was originally introduced in the CRR to mitigate the impact on SME loans of the general increase of capital requirements. In a report from March 2016, the EBA has assessed the effect of the supporting factor. The EBA concludes, on the basis of an empirical analysis, that it cannot be demonstrated that the supporting factor has led to increased access to credit for SMEs relative to large enterprises.

Danmarks Nationalbank does not find that small businesses should have special treatment in the form of adjustment of risk weights. Such an arrangement would be contrary to the efforts to ensure that risk weights reflect actual risk on the exposures to the greatest possible degree. Consequently, Danmarks Nationalbank suggests that Denmark reject the proposal to retain the supporting factor arrangement for SMEs.

Yours sincerely

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