FINANCE
DENMARK

Responses to the EU Commissions exploratory consultation on the finalisation of Basel III

April 12, 2018
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General questions:

a) What are your views on the impact of the revisions on financial stability?

A Danish Government Expert Group published in February 2018 a report on the effects of the Basel Committees package of amendments from 7 December 2017 (Basel III: Finalising post-crisis reforms) and the FRTB amendments that are currently discussed in the risk reduction package from November 2016. The report estimated a very significant increase in total capital requirements for Danish IRB Banks of approximately 34 % compared to today's requirements, or just over € 10 billion. If the effects stemming from the FRTB amendments were removed from the reports calculations, the report show estimated overall increases from the package of amendments covered by the Commissions consultation of approximately 29 % or € 8.9 billion.

The overwhelmingly dominating driver for this very substantial increase in overall capital requirements for Danish IRB banks is the output floor of 72.5 %. The reason why the floor has such a significant effect on Danish IRB banks' capital requirements is that the risk weight in the standardised approach, especially in segments where Danish IRB banks are particularly exposed (exposures covered by real estate property up to typically 60 % to 80 % LTV and unrated corporates) do not appropriately reflect the low risk of these exposures in Denmark.

Such a significant increase in capital requirements will necessitate a large build-up of the capital base of Danish IRB banks. This accumulation of capital, which we do not consider necessary, must be paid for by bank customers in the segments most affected by the output floor and bank shareholders in combination.

Seen in isolation, from a static portfolio perspective, this will undoubtedly add to the robustness of the Danish banking sector and thus increase financial stability, but not in a way anticipated by the international standard setter, where again and again it was emphasised that the new standards should not result in a substantial increase in overall capital requirements.

Moreover, we do not believe that the effect on financial stability from such an unwarranted increase in capital requirements rests on a sound foundation. The capital requirement framework will be less aligned with the models that banks use to control and price risk and on which they base their business decisions. In the longer perspective, this may shift banks portfolios away from the mostly low risk loan segments most affected by this misalignment, and drive banks towards riskier loan segments, which may decrease financial stability within the banking sector, contrary to the intention of the revised standard.

The Danish Government report on the effect of the output floor shows a significantly higher increase in capital requirements than EBA's assessment of the impact of the Basel reform on EU banks from 20. December 2017 (link). EBAs report showed an overall increase in capital requirements of 12.9 %. There are several factors that make direct comparisons difficult between the estimated increase in the Danish report and the EBA report, but one very important difference is that the EBA calculations did not include increases due to the application of the output floor on SIFI-buffer requirements and Pillar 2 requirements.

b) What are your views on the impact of the revisions on the financing of the economy?

In markets like the Danish market were the risk weights of the new standardised approach do not fit local credit risk conditions the output floor based on the standardised approach will increase capital requirements and disconnect regulatory capital from banks' internal risk management and loan pricing.

The increase in capital requirements will be very substantial. The total increase in Denmark is estimated to be approximately 29 %, or just over €8.9 billion (excluding effects from coming FRTB amendments).

Such a substantial increase in total capital requirements will drive up loan margins, especially in the most affected loans segments, and potentially slow down economic growth.

It may also have profound effect on the business model of IRB banks. Banks will be faced with inducements to change their business model towards more riskier loan segments. Banks would have to choose whether to base their internal risk management and capital allocation on regulatory capital requirement or on their models for assessment of inherent risk. Whatever choice they make it will always be suboptimal compared to a framework where regulatory capital requirements are better aligned with the banks' own risk assessments.

1.Standardised approach for credit risk (SA-CR)

Specific questions:

a) What are your views on the revisions? Please provide details.

All in all we can support the revisions of the standardised approach with two major reservations.

- Unrated, non SME corporates
- Risk weights for loans secured by immovable property

We believe that the calibration of risk weights in these two areas is particularly misaligned with the actual risk in the Danish market and most likely in many other European markets.

The standardised approach for corporates penalizes banks in jurisdictions that allow the use of external ratings for regulatory purposes (e.g. Europe) as opposed to jurisdictions where external ratings are not allowed for regulatory purposes (e.g. US). In the latter case banks can assign a 65 % risk weight to exposures to "investment grade" corporates, whereas in the former, they must apply a 100 % risk weight for externally unrated corporate exposures.

The 100 % risk weight for unrated corporates may be calibrated appropriately in markets where external ratings for midsized corporates are the norm. External ratings are important for in markets where capital market funding plays an important role. In such markets one would typically expect that weaker unrated corporates may withdraw from capital market finance - and therefore also external ratings - and instead rely on bank finance. In continental Europe capital market funding for corporates is not the norm, and therefore we would not expect an adverse selection of unrated corporates relying on traditional bank funding.

External ratings are important in other exposure classes in continental Europe. Therefore we would not recommend a solution were external ratings are generally not recognized for regulatory capital purposes and where all "investment grade" corporates are treated with a risk weight of 65 %. Instead, we urge the

European legislators to develop an European solution where sound unrated European corporates will be subject to a similar differentiated risk weight for "investment grade" corporates as in other jurisdictions.

With regard to loans secured by immoveable property, we are generally concerned that the risk weights of the standardised approach do not reflect the actual risk on these loans in Denmark. Average estimated risk weight for Danish retail mortgages loans calculated using the IRB formula (including the LDG floor of 10 % at portfolio level and down turn LGD add on) show average risk weights in the area of 13-17 %. Evidence on loss experience of European IRB banks transposed into risk weights by using the IRB formula suggests that an appropriately conservative starting point for risk weights in low loss jurisdiction in Europe could be well below 20 % for loans beneath the 80 % LTV bracket (Source: EBAs Fourth report on the consistency of risk weighted assets, June 2014).

Apart from the two mentioned major reservations there are number of other issues in the standardised approach for credit risk which are important to address in the transpositions into European legislation e.g.:

- The existing rules regarding property valuation and monitoring of property values in the CRR should be kept.
- The possibility to apply the alternative "loan splitting" approach should be implemented in the EU. Moreover, this approach should be applicable for all loans secured by immovable property, including where repayments are dependent on cash flows generated by the property.
- A nominal OC-requirement of 10 percent is highly problematic. We note and welcome that the OC issue is currently being addressed in the context of the European Commission's covered bond package, taking account of EU specificities.
- Ships should also be part of the cover assets in a covered bond as we know it from UCITS Art. 52.4 and CRR, Art. 129.

b) How would the revisions impact you/your business? Please specify and provide relevant evidence.

More specifically:

i. How does the revised SA-CR compare to the current approach in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revi-

We have not access to data to be able to give a reliable estimate of overall capital impact for Danish banks of the revisions to the standardised approach for credit risk. We would expect a main driver for increases in capital requirements under the revised SA-CR will be the new 10 % credit conversion factor (CCF) to be applied to commitments that are unconditionally cancellable at any time.

ii. Do the revisions affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible.

We realise, that the risk weight for unrated corporates has not been changed in the revised standardised approach compared to the exiting framework, and that risk weights in some segments of loans secured by immovable property have actually decreased. However, as the revised standardised approach will become the basis for the output floor for IRB institutions, the calibration under the standardised approach will have more far reaching effects.

Moreover, the proposed new more favourable risk weight of 75% for BBB rated corporates compared to 100% in the existing framework will have very little effect because relatively few corporates in EU are externally rated.

c) Where do you expect particular implementation challenges and why? Please specify.

2. Internal ratings-based (IRB) approaches for credit risk

Specific questions:

a) What are your views on the revisions? Please provide details

b) How would the revisions impact you/your business? Please specify and provide relevant evidence.

A Danish Government Expert Group published in February 2018 a report on the effects of the Basel Committees package of amendments from 7 December 2017. According to this report the effects of the revised IRB approach, including the new restrictions, would be overshadowed by the output floor.

More specifically:

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i. How do the revised IRB approaches compare to the current approaches in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

According to the Danish Government Expert Group report the revised IRB approaches compared to the current approach would increase capital requirement by approximately 5 % if the output floor was not applied.

c) Where do you expect particular implementation challenges and why? Please specify.

We are concerned about the very restricted use of own estimates of CCF factors in combination with the LGD input floors. In most cases the CCF factors from the standardised approach will have to be used. This will lead to differences between expected losses calculated for accounting purposes (IFRS 9) and expected losses calculated for capital requirements

3. CVA risk framework

Specific questions:

a) What are your views on the revisions? Please provide details.

The IMA-CVA proposed in the July 2015 consultative document has been removed (as proposed in the March 2016 consultative document). In our view, the IMA-CVA approach is more risk sensitive than both the SA-CVA and BA-CVA and should therefore still be an option in the regulatory framework.

In the SA-CVA the equation used for aggregation across buckets (paragraph 52 on page 119 in the Basel document) is to be calibrated according to the SA-TB approach which is currently being reconsidered by the Basel Committee for Banking Supervision. It is important that specific European foreign exchange mechanism that can have a positive effect on general interest rate correlation will be recognised when the Basel framework is transpose into European regulation.

The risk weights and correlations in the SA-CVA are intended to match the ones in the SA-TB approach. Hence, any recalibration of the SA-TB done by Basel or in the EU implementation should be reflected in the SA-CVA. Furthermore, it is important to take account of European specificities when implementing the Basel SA-CVA framework in a manner consistent with the implementation of the SA-TB framework, e.g. correlation between ERM 2 currencies in the general interest rates risk buckets.

b) How would the revisions impact you/your business? Please specify and provide relevant evidence.

More specifically

i. How does the current CVA framework compare to the revised one in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

c) Where do you expect particular implementation challenges and why? Please specify.

d) What are your views on the revised CVA framework to capture CVA risks arising from counterparties currently exempted from the own fund requirements for CVA risks under Article 382 of the CRR?

We have not available quantitative data on the effect of the new SA CVA or BA CVA. However, we are concerned that a removal of the present exemption of non-financial corporate counterparties from CVA capital requirements will significantly increase the capital requirements for CVA risks and for many banks result in increases much larger than the effect from the changes to the Basel framework itself.

4. Operational risk framework

Specific questions

a) What are your views on the revisions? Please provide details.

b) How would the revisions impact you/your business? Please specify and provide relevant evidence.

More specifically:

i. Which approach for the calculation of the operational risk requirement do you use at the moment?

ii. How does the new approach compare to your current approach in terms of capital requirements? Please provide an estimate, if the positive or negative difference is significant in your view, and specify the relevant revision(s).

A Danish Government Expert Group published in February 2018 a report on the effects of the Basel Committees package of amendments from 7 December 2017. According to this report based on data form larger IRB banks, the revisions in the operational risk standardised would increase capital requirement for operational risk by 12 %, or a 1 % increase in overall capital requirement if no output floor.

c) Where do you expect particular implementation challenges and why? Please specify.

5. Output floor

Questions:

a) What are your views on the revisions? Please provide details.

The proposal for a permanent output floor based on the proposed new standardised approaches will effectively abolish the risk based approach for capital requirements for banks operating in low risk markets.

We regard this as a major setback that will potentially have negative effects on banks' incentives for improving models and risk management.

We also regard the output floor as unnecessary given the current possibilities to address model risk under Pillar 2 and the initiatives underway to enhance confidence in the application of IRB models and reduce undue variability. Furthermore, the introduction of the leverage ratio requirement as a "hard capital requirement" as proposed in the Commission's Risk Reduction Measures from November 2016 will provide an effective capital back-stop for risk based capital requirements, including capital requirements based on the IRB approach.

a) How would the revisions impact you/your business? Please specify and provide relevant evidence.

IRB banks operating under well-functioning mortgage systems an in in comparably stable and solid economic conditions will be severely hit by the proposed capital floor.

The capital requirement framework will be less aligned with the models that banks use to control and price risk and on which they base the business decisions. This will adversely affect the conditions for financing housing and corporates exposures. In a longer perspective, this may shift banks portfolios away from predominately low risk loan segments most affected by this misalignment, and drive banks towards typically riskier loan segments, which may decrease financial stability within the banking sector.

With regard to loans secures by immoveable property we are generally concerned, that the risk weights of the standardised approach do not reflect the actual risk on these loans in Denmark. Generally estimated risk weight for Danish retail mortgages loans calculated using the IRB formula (including the LDG floor of 10 % at portfolio level and down turn LGD add on) show average risk weights in the area of 13-17. Evidence on loss experience of European IRB banks transposed into risk weights by using the formula given in the Basel III suggests that an appropriately conservative starting point for risk weights in low loans jurisdiction could be below 20 % for loans beneath the 80 % LTV bracket (Source: EBAs Fourth report on the consistency of risk weighted assets, June 2014).

More specifically:

i. What would be the impact of the revised output floor in terms of capital requirements when compared to the application of the revised internally modelled approaches? Please provide an estimate, if the impact is significant in your view, and specify the relevant driver

The positive difference between the revised output floor and the application of the revised internally modelled approaches for Danish IRB banks can be estimates to approximately 24 % (total increase from the application of the output floor is estimated to be approximately 29 %, (excluding increases due to FRTB) minus the estimated increase in capital requirements from the application of the revised internally modelled approaches (IRB) if no output floor of approximately 5 %.

ii. Does the application of the revised output floor affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects? Please support your view with specific evidence to the extent possible.

The introduction of an output floor will increase capital requirements mainly in the corporate exposure classes and for exposures secured by real estate. Banks with relatively high portfolio concentrations in those sectors might try to decrease their low risk business and actively target high risk customers/exposures. Such an increase in risk would not result in higher capital requirements as long as the bank is "below the requirements of the output floor". This again may lead to a downward pressure on margins for higher risk customers/exposures, which in our view is not in the interest of the European Union and its member states.

c) Where do you expect particular implementation challenges and why? Please specify.

The implementation of the capital floor into the EU legislation should be considered carefully. It should be accompanied by a thorough analysis in order to assess which parts of the current capital requirement framework already covers the same risk as the risk which the Basel output floor is supposed to cover. It may well be the argued that higher capital requirements stemming from a binding output floor would supersede the need for additional domestic SIFI buffer requirements and Pillar 2 buffer requirement add-ons.

We note that EBA did indeed omit the domestic SIFI buffer requirements and Pillar 2 in their calculations of the effects of the Basel IV output floor (link).

One possibility could be to calculate the output floor exclusively on the specific minimum capital requirements and buffers set by the Basel Committee for Banking Supervision and not on the elements of the capital requirement framework that are not covered by these specific minimum requirements (Pillar 2 capital requirements, domestic SIFI-buffer requirements and the EU Systemic risk buffers (SRB))

Basel minimum capital requirements and buffers (as of 1 January 2019):

- Pillar 1 (4.5 % CET1, 6 % Tier1, 8% total capital)
- A capital conservation buffer of 2.5 % CET1
- A counter cyclical buffer within a maximum, set by national authorities
- A G-SIB buffer for largest global banks

Any possibility to implement a Basel compliant output floor into EU regulation in a way that significantly increases the possibility for retaining a risk sensitive capital requirement framework deserves careful consideration.