

29 January 2016

Call for evidence - EU REGULATORY FRAMEWORK FOR FINANCIAL SERVICES of 30 September 2015

A) Rules affecting the ability of the economy to finance itself and grow

1) Unnecessary regulatory constraints on financing

Example 1.1 CRR + SME

To which Directive(s) and/or Regulation(s) do you refer in your example?

CRR Regulation (EU) No 575/2013 / CRD - Directive 2013/36/EU

Please provide us with an executive/succinct summary of your example:

The revised regulatory framework seems to be a constraint in regards to financing certain segments considered and historically proven as low risk. For instance the Basel I capital floor requirement stated in the CRR does little to promote risk sensitivity in the capital requirements and is unreasonably punitive for a number of institutions. In addition, the expected introduction of a binding leverage ratio requirement in the coming years has the same effect – especially for specialised institutions with high volumes of low risk assets on their balance sheets e.g. the Danish Mortgage Banks. As a possible consequence, this might reduce the willingness to finance low risk segments or increase loan costs in these segments.

A simple example of the above mentioned disadvantage is given through a comparison of a “low risk” institute A and a “high risk” institute B. Assuming a required Tier 1 capital requirement of 15 percent of the Risk Exposure Amount (REA) and a leverage ratio requirement (Tier 1) of 3 percent of the total assets, the two capital measures are equal for institute A, whereas the risk based capital requirement is the binding measure for institute B. If both companies were to increase its balance sheet by 100 units of low risk asset such as mortgages, the marginal capital requirement would not be the same, only due to current composition of their balance sheet. Institute B is not limited by the leverage ratio, and as a result the increase of 100 units of assets with an average risk weight of 17 percent leads to an increase in capital requirement of 2.55 units ($15\% \cdot 17\% \cdot 100$). If institute A were to increase its balance sheet with the exactly same bucket of mortgages the increase in capital

requirement would be 3.00 units (3%*100). The binding leverage ratio leads to a 0.45 unit difference – equal to approximately 18 percent. Hence with a binding leverage ratio it requires more capital for the “low risk” institute A to engage in new low risk business than it does for the “high risk” institute B. This is not appropriate.

		Institute A "low risk"	Institute B "high risk"
a	Capital requirement - T1	15%	15%
b	Leverage Ratio requirement (LR) - T1	3%	3%
c	Balance sheet/LR exposure measure	1.000	1.000
d	Average risk weight	20%	40%
e	Risk Exposure Amount (REA) (c*d)	200	400
f	T1 requirement - determined by REA (a*e)	30	60
g	T1 requirement - determined by LR (b*c)	30	30
New assets 100 units of residential property mortgages - average RW = 17%			
h	New balance sheet/LR exposure measure	1.100	1.100
i	Risk Exposure Amount (e+17%*100)	217	417
j	Average risk weight (i/h)	19,73%	37,91%
	T1 requirement from REA (a*i)	32,55	62,55
	T1 requirement from LR (b*h)	33,00	33,00
	Increase in required T1 capital	3,00	2,55

Financial institutions generally use a risk-adjusted return on capital (RAROC) approach to assess loan margins based on the associated risk and capital requirements on each individual loan. Low risk loans have lower loan margins than higher risk loans, but low risk segments also require less capital. The RAROC assessment ensures that it is profitable to engage in both segments by requiring a minimum loan margin that is consistent with the return requirements on capital.

As the example shows the introduction of a binding leverage ratio can increase the amount of capital required for low risk lending. If market prices (margins) on low risk loans are unchanged, the financial institutions' RAROC on low risk loans becomes too low in comparison with RAROC on higher risk loans. Therefore, a binding leverage ratio can increase financial institutions appetite for more risky loans at the expense of low risk business as it becomes unprofitable to have low risk/low margin loans on the balance sheet.

In regards to SME financing it is our opinion that the SME supporting factor has the potential to increase access to funding and possibly lower prices for this particular group of businesses. However the impact of the SME supporting factor has been limited by the uncertainty as to whether it will become permanent. This means that several institutions do not factor in this discount in their capital allocation/planning, pricing and loan decisions. As

such it is considered of great importance that the capital discount for SMEs is prolonged and made permanent to support further growth.

In addition to the abovementioned a relaxation of the required documentation of SMEs could also promote further use of the reduced capital requirements and thereby provide more businesses with favourable possibilities of financing.

2) Market liquidity

Example 2.1 CRR: LCR, NSFR and leverage ratio (LR)

To which Directive(s) and/or Regulation(s) do you refer in your example?

CRR Regulation (EU) No 575/2013.

Please provide us with an executive/succinct summary of your example:

In regards to market liquidity, the introduction of the Liquidity Coverage Ratio (LCR) and an expected introduction of Leverage Ratio (LR) in the new regulatory framework seems to have had some effect. In general a lack of or decrease in risk capacity with the market participants has resulted in decreased liquidity and increased volatility in financial markets globally. These trends have been seen on some of the most liquid markets such as the market for German and US government bonds. High volatility and intraday illiquidity is also seen in usually extremely liquid instruments such as the 10-year German bund future.

In a Danish context, the new rules have had consequences on market liquidity as well as the cost of mortgage bonds – both short-, medium- and long-term bonds. In the last 6 months, the spread on Danish 3-year ARMs has increased by more than 30 bps. A similar increase is seen for the long callable bonds. These increases are largely driven by balance sheet and capital constraints and a lack of repo capacity with the investors and other market participants.

In addition, the requirement of issue size to achieve 1B status in the LCR has resulted in wider spreads between smaller and larger series. For series issued by the same institution, difference in spreads of around 15 bps between smaller and larger series in the medium term segment has been observed recently.

LCR requires credit institutions to hold specific assets (defined as liquid assets, i.e. level 1A, 2A, 2B assets) in their liquidity buffer. Turnover in these assets is reduced because, investors have to hold on to them in order to meet the LCR requirements. At the same time, bonds not qualifying as liquid assets in LCR (for instance due to rating or volume/outstanding amount requirements) are not traded as frequent either, as they do not count in institution's liquidity buffers. Furthermore, the expected leverage ratio requirements reduce the risk capacity in the financial system, meaning that investors are restricted

in taking new positions – especially in low risk assets. This also reduces market liquidity as fewer market participants are willing to stand up as risk takers/buyers in the market. Normal repo financing arrangements are also diminished as feasible funding instrument due to gearing ratios and also due to the complex implementation of LCR. When calculating LCR, short termed repo financing must be subtracted level 1A positions leaving the institute with lower levels of level 1A assets and also lower levels of level 1B, 2A and 2B due to the cap on non-level 1A assets. Therefore, LCR will deteriorate when entering repo financing arrangements. As a consequence, repo financing can no longer contribute to market liquidity in the same degree as it could earlier on.

The decreasing liquidity in the market is followed by less market making activity and a reduction of the number of covered bonds where firm quotes are available for trading as well as for price indications. This has negative consequences for the Danish mortgage borrowers (e.g. homeowners and SMEs) both when selling covered bonds at loan pay out and when buying the underlying covered bonds at redemption or partial prepayment.

Example 2.2 MiFIDII + MiFIR

To which Directive(s) and/or Regulation(s) do you refer in your example?

MiFIDII directive 2014/65/EU and MiFIR Regulation (EU) No. 600/2014

Please provide us with an executive/succinct summary of your example:

The objective of the new transparency-regime under MiFIR is to increase the transparency in the market for non-equity. It is important that the coming standards are minimum standards. This means that markets that already apply high transparency standards for non-equity can maintain the high standards also after MiFIR enters into force. The new transparency-regime in MiFIR must not limit the transparency already in existence.

As an example in Denmark the post-trade system for covered bonds is well-established: All trades (including OTC) are reported to NASDAQ Copenhagen and published no later than three minutes after execution making the market very transparent. Reporting of trades exceeding DKK 100 mn (approx. EUR 14 mn) may be delayed until the end of the business day, but for 45 per cent of the trades above 100 mn this possibility is not exercised. The high degree of transparency is important to the functioning of the covered bond market and this must not be challenged or limited by new rules that aim to increase transparency.

3) Investor and consumer protection

Example 3.1 Mortgage credit directive – ESIS

To which Directive(s) and/or Regulation(s) do you refer in your example?

Mortgage Credit Directive 2014/17/EU

Please provide us with an executive/succinct summary of your example:

The intention of the Mortgage Credit Directive (MCD) is to create a unified framework for the provision of financing and to provide customers relevant, comprehensive and consistent information about products. This aim is among other things to improve comparability and assist consumers making informed decisions. Part of the directive is the ESIS (European Standardised Information Sheet) which aims to give standardised information to consumers on mortgage loans. The form has a fixed structure with mandatory text and required information in order for the consumers to compare different products – also across borders. We find that the use of ESIS in the coming years should be carefully examined in order to review whether the structure and content of ESIS provide consumers with optimal information relevant for them or whether improvements to ESIS can be made.

4) Proportionality / preserving diversity in the EU financial sector, which, and how?

Example 4.1 Single rule book

To which Directive(s) and/or Regulation(s) do you refer in your example?

Single rule book initiative.

Please provide us with an executive/succinct summary of your example:

The aim of a Single Rulebook and the move away from national discretion makes it increasingly difficult for financial institutions to operate with specialised business models. The “one-size-fits-all” approach is calibrated to an average across institutions and with less room to deviate from these requirements, the institutions is driven towards this average. As a consequence the systemic risk in the European banking sector will increase as the ability to act differently in times of distress diminishes.

Examples of these constraints are the leverage ratio as a binding capital constraint due to focus on low risk assets and to a certain extent also floor requirements being more restrictive on certain exposure classes and/or jurisdictions and/or business models.

Example 4.2 Single rule book and NSFR

To which Directive(s) and/or Regulation(s) do you refer in your example?

Single rule book initiative. NSFR

Please provide us with an executive/succinct summary of your example:

Regulation has in general become more detailed. The risk is that it generates very similar institutions, which might be reinforced when authorities benchmark institutions against each other and thereby implement best practices without any guarantee that it is best practice in all scenarios. If institutions become very similar, they might also be hit by the same financial and economic shocks and, furthermore, probably want to liquidate positions in the same way and at the same time. The risk is that the whole system comes under stress because participants are very similar. In this sense, diversity might be better, as it is easier to manage a few individual institutions under stress as opposed to a whole system of very similar participants.

To sum up, it might be a good idea to avoid very detailed regulation as it makes individual institutions want to do the same. For instance buy and hold sovereign bonds, creating excess demand and negative interest rates on sovereigns in some countries. Another example could be NSFR, where the EBA calibrations show that specialised institutions like Danish Mortgage Banks can not make the requirements – even though these institutions proved robust during the recent crisis and have embedded liquidity risk mitigations (for instance regulatory requirements of extendable maturity of short term funding instruments). The risk is that the RSF/ASF parameters assumed by Basel in their NSFR proposal end up supporting specific funding and business models without any back testing of whether these models actually perform better in stress scenarios. Worst case is that real life robust business and funding models have to change fundamentally in order to be NSFR compliant.

Example 4.3 Asset encumbrance is not an issue in covered bonds models as there is no deposits

To which Directive(s) and/or Regulation(s) do you refer in your example?

CRR Regulation (EU) No 575/2013 - reporting and LCR. BRRD (structural subordination of simple senior creditors)

Please provide us with an executive/succinct summary of your example:

It is important to make a distinction between asset encumbrance as defined in relation to CRR reporting / BRRD (structural subordination of simple senior creditors) and as defined in relation to the LCR (access to liquidate assets in order to fulfill payment obligations).

As an example, if defined in relation to CRR reporting/BRRD, Danish mortgage banks have - by their very design- an asset encumbrance ratio of virtually 100 percent since covered bonds are the only legal funding instrument for lending in those institutions, however no deposits may be taken. Assets in cover pools make up the entire balance sheet of Danish mortgage banks.

Such 'full asset encumbrance' could have extreme and unintended consequences if all assets – including in all other ways LCR-compliant liquid assets – were to be considered encumbered under all material circumstances. Thus, non-compliance with the LCR would be guaranteed.

This would in no way reflect actual liquidity. The 'encumbered' assets are not tied up in any absolute sense, nor are they unavailable for their intended purposes. In fact, they are fully available to cover the relevant liquidity outflows, for example via payments to the covered bond holders. This complies with the definition of asset encumbrance in the LCR Delegated Act.

In other words, there is no encumbrance "in the wrong direction". The liquid assets in the cover pools are, thus, not encumbered in a material way that prevent them for being liquidated (e.g. by being used as collateral in a repo) and – though being in a covered bond cover pool – do not lead to any structural subordination of simple depositors.

Example 4.4 There should be room for diversity in business models

To which Directive(s) and/or Regulation(s) do you refer in your example?

General comment to regulation and harmonisation

Please provide us with an executive/succinct summary of your example:

Common rules have a great potential to support growth and employment in the EU. However, it is important to make room for diverse efficient business models, such as the Danish mortgage model. Harmonisation and standardisation of rules may also lead to less competition and harm the market supply. This may happen if harmonisation forces suppliers away from the market or if it leads to fewer variables to compete on.

Denmark may be challenged by harmonisation of financial rules, as the European or international rules are often harmonised according to a universal banking model. The major part of Danish loans are granted by mortgage banks operating under a specialised banking model. In other words, Danish mortgage banks may risk being forced out of the market, because they fund their loans differently than universal banks. Consequently it may lead to more expensive and less favourable loans, but it could also lead to less financial stability. Thus it is essential that business models are not harmonised.

B) Unnecessary regulatory burdens

5) Excessive compliance costs and complexity

Example 5.1 EMIR

To which Directive(s) and/or Regulation(s) do you refer in your example?

EMIR – Regulation (EU) No. 648/2012

Please provide us with an executive/succinct summary of your example:

Based on the feedback received from our members, some expressed the concern that the potential market impact of both EMIR and the subsequent regulatory technical standards was not assessed thoroughly enough before their adoption, which could ultimately result in extra costs for the financial sector. Considering this, it could be argued that the implementation and the outcome of EMIR would have been more successful, if more resources had been dedicated to designing a model to be implemented in practice prior to launching the regulatory process.

Therefore, while acknowledging that the EMIR requirements serve a purpose, it is also important to consider the impact they will have on the industry. As for all business types, costs incurred are covered by the revenue, meaning that customers ultimately pay more for their purchases. For instance, in the case of mortgage lending, the additional cost will affect the price of the loan for prospective borrowers, which may in turn reduce economic growth. With this in mind, the right balance between prudential regulation and economic growth should be sought to ensure that growth potential is not sacrificed in favour of more regulation and reporting.

6) Reporting and disclosure obligations

Example 6.1 EMIR and MiFIR

To which Directive(s) and/or Regulation(s) do you refer in your example?

EMIR – Regulation (EU) No. 648/2012, MiFIR – Regulation (EU) 600/2014 and MiFID – Directive (EU) 2014/65

Please provide us with an executive/succinct summary of your example:

There are some ongoing impediments or unintended consequences with regard to meeting trade reporting obligations as per Article 9 EMIR.

For instance, the setup and specification trade reporting has been finalised late in the process leaving a limited amount of time for the industry to implement. In the implementation phase, the specification has been changed adding extra cost and complexity to the industry. Guidance to understand the trade reporting regime and technical details on how to fill in different fields in the trade reports has often been accompanied by frequent changes and new additions to the Q&A document prepared by the European Securities and Markets Authority (ESMA). It is important to note that besides the initial cost in introducing a new reporting system, there is also the extra cost incurred by frequent changes to this system, even though each change might be initially considered as a minor one.

In addition, the abundance of fields and the possibility of variations within each field make the reconciliation process extremely difficult, especially without any clear guidelines for the process. A suitable example could be given with the fields concerning price/rate and price notation where only a combination of the two fields makes the reconciliation meaningful. In general, a smaller number of fields and a higher focus on the quality of the reconciliations process would provide much more useful information. The overall result is an extensive and complex reporting system, which is interpreted differently by the counterparties which could lead to producing unmatched reports from counterparties. From an industry perspective, the quality and usability of the received data is questionable. Therefore, reasonable care must be taken in order to establish a manageable and well-functioning reporting system.

Furthermore, we are concerned that the same “mistakes” are about to be made in relation to MiFIR with regard to the transaction reporting and data collection obligations (data related to transparency and best execution). The amount of fields to be reported or data to be published/collected is immense and the time for the Industry to implement is shortened due to the fact that the level 2 regulation is delayed. Also the Competent Authorities and ESMA have to develop systems that can receive the data and the Industry has to have time to test against this system. This could lead to the same issues as with EMIR with frequent changes and short deadlines to be met and more importantly extensive, expensive and complex systems where the quality and usability of the received data is questionable.

7) Contractual documentation

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8) Rules outdated due to technological change

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9) Barriers to entry:

Example 9.1 – Barriers to entry

To which Directive(s) and/or Regulation(s) do you refer in your example?

Combined effect of directives and regulation increases requirements on multiple areas hence effectively acting as barriers to entry.

Please provide us with an executive/succinct summary of your example:

The combined effect of directives and regulation increases requirements on multiple areas hence effectively acting as barriers to entry. The amount of resources needed to comply with rules and regulation makes it costly to enter the European financial market, this can prohibit some entrepreneurs from entering the financial market.

A complex regulatory framework makes it very difficult for new entrants. It has become very resource intensive to be up date and compliant with new regulation, including reporting requirements, monitoring new regulatory initiatives, implementing delegated acts etc.

C) Interactions of individual rules, inconsistencies and gaps

10) Links between individual rules and overall cumulative impact

As we are in the early stages of the new regulatory regime, a full overview and call for cumulative impact assessment seem premature. Some of the individual elements and requirements has not yet or has just come into force, and by doing this assessment now, you could easily overlook some unintended consequences and inconsistencies simply because these have not been encountered yet.

However, we have already observed negative regulatory effects for instance on market liquidity and market prices. Therefore, as we agree that this question is of very great importance we recommend that this assessment of cumulative impact and link between rules should be carried out on a current basis in order to monitor and be able to react to the development of unintended consequences.

11) Definitions

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12) Overlaps, duplications and inconsistencies

Example 12.1 – NSFR vs. LCR

To which Directive(s) and/or Regulation(s) do you refer in your example?

CRR Regulation (EU) No 575/2013 (NSFR, LCR). Solvency II Directive (2009/138/EC)

Please provide us with an executive/succinct summary of your example:

In general, there is a risk, that covered bond markets get more segmented due to regulation. When regulation is directly or indirectly restricting what issuers should issue and what investors can buy, a consequence might be, that the market does not clear as there is no match between sellers and buyers.

In this respect, there is a potential mismatch between the funding requirements in NSFR and the investor requirements in LCR. NSFR requires long term funding, whereas LCR as a liquidity buffer requires investing in short termed liquidity instruments – and only those qualifying as level 1A, 1B, 2A or 2B.

Example 12.2 PRIPS vs. Prospectus Directive

To which Directive(s) and/or Regulation(s) do you refer in your example?

Directive 2003/71/EC (the "Prospectus Directive"). Regulation (EU) No 1286/2014 ("PRIIPs")

Please provide us with an executive/succinct summary of your example:

The Summary in the Prospectus Directive serves basically the same purpose as the KID and therefore a great deal of the information in the Summary and the KID are the same. It seems that both issuers and investors would benefit from an alignment of the Summary and the KID.

13) Gaps

D) Rules giving rise to possible other unintended consequences

14) Risk

Example 14.1 – Unintended risks/consequences

To which Directive(s) and/or Regulation(s) do you refer in your example?

Combined effect of various directives and regulations.

Please provide us with an executive/succinct summary of your example:

The asset classification in LCR has a different purpose than the classification under NSFR. The LCR categorisation is used in a stress measure where assets are to be liquidated during a 30 day period. Whereas NSFR is a structural funding ratio measuring the degree of long term funding. When setting the criteria for the calculation of the NSFR it is important that all unencumbered high quality covered bonds count with low RSF-factors – including min. AA rated non-HQLA covered bonds – since these covered bonds have proven to be liquid at least over a 1 year horizon.

Covered bond series are built up gradually by Danish mortgage banks by daily tap issuance corresponding to the daily loan activity. This matchfunding, means that funding, market and liquidity risks are eliminated. Hence there is no pipeline risk but it takes time to build up the covered bond series. Smaller institutions get a regulatory created competitive disadvantage as return requirements on smaller issue sizes are increased – only due to the fact that investors can not use them as liquid assets in LCR. At the moment, DKK interest rate spreads on covered bonds due to differences in LCR status/issue size is about 15 bps. In a transparent match funding system with small margins (< 80-100 bps.), as the Danish Mortgage System, this is a huge competitive disadvantage. This, in combination with the very high degree of transparency, has always been the backbone of the Danish system. Ultimately this will also lead to negative consequences for Danish mortgage borrowers (e.g. homeowners and SMEs).

15) Procyclicality

Example 15.1 – Unintended risks/consequences

To which Directive(s) and/or Regulation(s) do you refer in your example?

CRR Regulation (EU) No 575/2013.

Please provide us with an executive/succinct summary of your example:

Procyclicality stems for example from:

1. Increasing capital or liquidity requirements during downturns – especially when implemented with large cliff effects, so that small changes in economic fundamentals create dramatic increases in regulatory requirements. One example is the way external ratings are used in the regulation. Even small rating downgrades during economic downturns might result in dramatically higher capital requirements. For example, one (small) rating notch can change the credit quality step of a covered bond and result in a double up (or more) in investors' risk weight according to the mapping structure of rating/credit quality step/risk weight. Similarly assets might lose their liquidity value in LCR if assets are downgraded one (small) notch to a lower credit quality step. The consequence might be that institutions/investors are short of liquidity and capital due to rating related cliff effects. In a risk management and compliance perspective, these regulatory created cliffs give rise to extra concerns – especially when investments are placed on a regulatory cliff with one rating notch from doubling the capital requirements, losing LCR liquidity value, or the like.
2. Extra collateral requirements in CRR on covered bonds in economic downturns with falling property prices also have procyclical effects and works opposite the countercyclical buffer. Furthermore, in economic downturns it can be difficult and expensive to raise capital in the capital markets for the additional collateral requirements due to falling property prices.

If you have suggestions to remedy the issue(s) raised in your example, please make them here:

In general, we find that procyclical elements should be removed from regulation, so that requirements are stable through the cycle. This will support financial stability.

In general, cliff effects should be avoided. That is, small changes to bonds or counterparties (for instance a small rating change), should not have large impacts on capital requirements or LCR liquidity values etc. Instead, regulation could rely on markets' ability to assess a new fair value after a downgrade, as this new value reflects what market participants require to compensate them for the new risk assessment of the rating agency. Alter-

natively, the relationship between (for instance) rating and capital requirements/LCR liquidity values should be more linear without large discontinuous jumps/cliffs.