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Response by Swedish authorities to the Commission's consultation on potential changes in the CRD

Joint response to the Commission's open consultation on potential changes in the CRD from the Swedish Ministry of Finance, Sveriges Riksbank and the Swedish Financial Supervisory Authority – below called the Swedish authorities.

A. Large Exposures

Interbank exposures

The issue of large exposures limits for interbank exposures presents the legislator with an important dilemma. For credit risk purposes it is preferable to keep exposures at limited amounts and at short maturities. Contrariwise, for liquidity risk purposes it is desirable that the maturities of exposures are adequately long-term and that some flexibility in exposure amounts is allowed, in particular in stressed situations.

It is difficult to solve this dilemma by using only one set of rules, i.e. exposure limits for interbank lending. In CRD, credit risk obviously must be the primary motive for regulation. However, to the extent possible liquidity aspects should be recognised, and importantly, any new rules must be supplemented by adequate rules and supervisory measures for liquidity risk.

Against this background the Swedish authorities appreciate COM's initiative to revise the treatment of interbank exposures and can see the need for more restrictive rules. We are also pleased to see that the COM considers the situation of smaller banks in its proposal, by including a threshold in Article 111, paragraph 1(i). However, stricter rules may also imply some problems – especially for banks active in smaller currency areas. For Swedish banks – operating under these conditions – the COM's proposal would imply difficulties to diversify exposures, in particular under stressed circumstances.

COM has argued that interbank exposures with shorter maturities should not be exempted, since it would provide incentives for institutions to shorten their exposures. We share this view except for very short maturities. We believe that exposures with very short maturity fulfil a different purpose – liquidity management – compared to exposures with medium to long term maturities. Therefore an exemption for such

exposures would not, in our view, significantly affect the institutions' maturity structure. Also, if exposures with such short maturities were to be exempted, the liquidity management in the Swedish interbank market would not be significantly affected. The exact length of the maturities to be exempted is hard to decide, but considering the distribution of the maturity of liquidity of the banking system, which is heavily weighed toward the short end, we have come to the conclusion that exempting interbank exposures with maturities up to no more than two days could be a reasonable compromise. If so, the liquidity management in the Swedish interbank market would not be significantly affected and the risk for unforeseen events would still be radically diminished compared to the present exemption of twelve months.

Group of connected clients

Regarding interbank exposures, the Swedish authorities are concerned with the suggested broadening of the definition of "group of connected clients" in Article 4, paragraph 45. The combined effect of deleting the exemption of interbank exposures with a maturity of twelve months or less, and broadening the definition of "group of connected clients" could have a severe combined effect on the banking industry in Sweden and other MS with a concentrated bank market. In a concentrated bank market it is more difficult for institutions to diversify their exposures. If the major groups of financial institutions at the same time will be defined as a "group of connected clients" in Article 4, paragraph 45, due to funding interconnectedness, it would result in severe adverse consequences for the banking industry. Consequently, we propose that the COM clarifies that the term "group of connected clients" should not include institutions or groups of institutions reliant on the same funding sources.

Intra-group exposures

In principle, the Swedish authorities support the effort to tackle the important problem of ring fencing and can therefore understand the reason behind COM's proposal that MS shall exempt exposures to counterparties referred to in Article 80(7) a – e and 80(8). However, after due consideration, we see problems with the condition in 80(7) e and fear that the consequences could be severe. Firstly, the proposal could imply increased costs for the institutions. An institution with a subsidiary in a country with ring fencing mechanisms would no longer be able to have a central treasury function, thereby increasing capital costs for the institutions. It could also force institutions into a branch structure, which is not the objective with the proposal. Secondly, the interpretation of the condition in 80(7) e is unclear, making it difficult for the institutions to use the exemption. For example, there are restrictions in Swedish company law on transferring capital. Should such restrictions be interpreted as legal obstacles in condition 80(7) e? Thirdly, it would be hard to identify which countries fulfill the condition and there is a risk that the condition in 80(7) e would be interpreted differently in different MS. Fourthly, we think that it is unreasonable that institutions with cross-border activities situated in MS without ring fencing mechanisms should bear the consequences of ring fencing mechanisms in other MS. We would like to see a solution to the ring fencing problem at the EU level. But we also realize that it could be a long term project. Therefore, the Swedish authorities recommend the COM to urgently analyze the extent and severity of the ring fencing problem and consider the consequences of the proposal further.

Settlement issues

COM proposes that settlements of foreign exchange and securities transactions are excluded from the large exposure calculations if less than 48 hours/5 days have elapsed. The Swedish authorities take the view that certain settlement positions contains a counterparty "event risk" at a much earlier stage, in particular when the obligation to settle has entered into its irrevocable phase. Hence, the Swedish authorities propose that the COM urgently analyses whether or not such settlement positions should be included in the calculations of large exposures.

B Hybrid capital instruments

Question (iii) Quantitative limits on hybrid instruments

There is widespread consensus that including hybrid capital instruments into an institution's own funds, even with stringent eligibility criteria, will lower the quality of the own funds. On the other hand hybrid capital instruments give institutions some indisputable advantages, such as lower cost of capital and a diversified investor base, which must be considered when deciding which limits will apply. However, safeguarding the financial stability, by upholding the quality of an institution's own funds, must always be the overarching goal. An important feature of a set of rules that govern the limits on hybrid capital instruments is also that the legal text is unambiguous and easy to understand so that it will be applied in an harmonised manner and no loopholes emerge that will undermine the quality of an institution's own funds.

The COM's proposal is based on CEBS' option 2 which is suggested in CEBS proposal for a common EU definition of Tier 1 hybrids. The major differences are a definition of CEBS suggested additional features that make certain hybrids more similar to equity (by mandatory conversion in an emergency situation) and a raised limit for inclusion of hybrids that will not be converted into core capital in an emergency situation.

The Swedish view is that both of the proposals of CEBS for hybrid limits are too liberal and lower the quality of institution's own funds too much. However, we prefer option 2 compared to option 1 because of the inherent cliff effect in option 1 that might cause problems for institutions, particularly in times of stress. We believe that the COM's proposal, allowing even more 'low-quality hybrids' in Tier 1 compared to CEBS option 2, is a step in the wrong direction. We therefore urge the Commission to revise its proposal and at least adopt a proposal in line with CEBS option 2.

Technical issues

A technical comment in connection with hybrid capital limits is that 'emergency situation' should in some way be defined, or at least clarified, since the mandatory conversion in art. 66 will be triggered by such an event. It is not satisfactory that this will be open to interpretation since this will not lead to a harmonised implementation in this important matter. The term "Emergency situation" is also used in other important articles, e.g. art. 66 (4), which increases the need for clarification.

As regards the eligibility criteria in art. 63a (a) (permanence), we believe that the wording 'shall not be redeemed' is misleading since it gives the impression that it is

not against the rules per se to have a call instrument that may be redeemed before five years, but it is the action taken by an institution to actually use such a call before five years that is against the rules. The effect in practise might be the same, but the criteria should be designed so that hybrid instruments cannot feature such calls in the first place. Here, we prefer the wording 'shall not be redeemable' instead.

In the second subparagraph of art. 63a (a), we also believe that the wording 'provide for a moderate incentive' raises questions. If the purpose of the subparagraph is to say that only moderate incentives are allowed, it should be done in an other way. Preferably by stating in a separate subparagraph that "Instruments may only have a moderate incentive for a credit institution to redeem." If this is not the purpose, the wording raises the question how other incentives should be treated. And why does the wording only refer to 'undated' instrument here? The reference, we believe, is valid for both dated and undated instruments. "Moderate" should be left out.

In the second sentence of art. 63a (a), subparagraph three, either the word 'not' should be deleted, or the word 'either' should be deleted. The wording should be "The competent authorities may grant permission provided the request is made at the initiative of the credit institution and neither financial nor solvency conditions of the credit institution are effected."

The second sentence in article63a (b) states that a credit institution shall be obliged to cancel payments as soon as it approaches the minimum capital requirements. The third sentence implies that the competent authorities may require cancellation of payments although the credit institution fulfils the minimum capital requirements due to Pillar 1. Due to existing rules, payments can only be made if there are distributable earnings available. This condition is included in the contract for the instrument which means that some kind of legal interpretation must be made before cancellation of payments can be considered.

Current regulations have more of a company law perspective. The Commission's wording entails a change to a supervisory authority perspective. It is important that the Commission's proposal is applicable in practice for the competent authorities. With automatic cancellation of payments and the possibility for the competent authority to require cancellation of payments the limit should probably be lower than the minimum capital requirements. Otherwise, the competent authorities could be forced to make difficult judgements when a credit institution is approaching the legal limit for capital requirements.

The wording in 63a (c) is general and does not provide guidance for a common interpretation of loss absorption. There is still room for interpretation for member states and that does not support harmonisation. The Commission needs to clarify which instruments can be used by member states that are efficient in absorbing losses and which instruments aggravate recapitalisation.

The proposal in article 66 1a. (a) seems to imply a conservative view regarding the conditions for instruments that could qualify as hybrids that will be converted into "core capital" during emergency situations. Company law in different member states contains different conditions for instruments. It is important that member states can fulfil the conditions in the Commission's proposal without having to change their company law.

C. Supervisory arrangements

Systemically relevant branches

The Swedish authorities agree that it is reasonable to recognize branches which are significant for host countries. However, since the existence of such branches in relation to the CRD is only relevant in certain issues pertaining to home-host arrangements, the Swedish authorities prefer that the term "systemically relevant branches" is changed to a more neutral term, for instance ”branches relevant for extended home-host cooperation". We want to avoid the expression "systemically relevant" which have a wider meaning, in particular in crisis situations. It is also important to recognize that extended home-host cooperation is part of a larger set of issues, i.a. the question of burden sharing as outlined in the recently signed MoU on crisis management between Ministries of Finance, Central Banks and Financial Supervisors in the EU. In *this* directive, additional legal requirements on supervisory cooperation – above those stated in the draft – should therefore be avoided.

In addition, we believe that the lower threshold for considering whether a branch falls into this category should be at least 5% (market share of deposits) and preferably higher. It is important that an impact assessment is provided to find a suitable level. Furthermore, it is the view of Swedish authorities that decisions on "relevant branches" should be agreed jointly by home and host authorities. If agreement cannot be reached, the CEBS should have a role as a mediator.

Finally, in addition to the suggested arrangements for home-host cooperation the Swedish authorities would welcome measures that could facilitate for home supervisors to delegate tasks to the host.

Information exchange with central banks and ministries of finance

While the Swedish authorities support the COM proposal in Art. 49 and 50 to enable supervisory authorities to provide information to central banks, the interpretation of Art 51 might need to be clarified to ensure that it does not restrict such information exchange.

Information to CEBS

The last sentence in article 129 states that the consolidating supervisor shall inform the Committee of European Banking Supervisors of the activities of the college of supervisors, including in emergency situations. We suggests that this sentence should be removed. We think that this is an unnecessary burden for the authorities during the crises since it does not help in solving the situation. If COM still want to keep this we think that it will be enough if the authorities report the actions taking afterwards.

TECHNICAL CHANGES

Directive 2006/48

Article 87, paragraphs 11 and 12

p 11 (b) (i) It should be clarified that the cap applies on an aggregated level to all exposures treated according to (b)(i). The current wording do not make sense.

p 12 The first sentence should be harmonised with the proposed changes in paragraph 11. The sentence should be changed to something like this: ”Where exposures in the form of a CIU do not meet the criteria set out in Annex VI, part 1, points 77 and 78, <u>or for those underlying exposures of the CIU that the institution is not aware of</u>, the credit...”

p 12 (b) (i) Same comment as on paragraph 11 (b) (i).

Article 150, paragraph 1

(k) The items in Annex IV are not off-balance sheet items. We should take the opportunity to change this sentence to “the list and classification of off-balance sheet items in Annex II and <u>derivatives</u> in Annex IV.”

(m) This provision refers to ”amounts” and ”percentages” in Article 111 (1). But, Article 111 (1) just mentions one single figure: 25%. Therefore the sentence should be changed to “alteration of the percentage specified ...”.

Annex XII, part 2, point 10

(e) To reduce the possibility of misunderstanding, this requirement about disclosure should take the starting point in Directive 2006/49/EC, Annex V, points 4 and 8. The same terminology should be used, and the disclosure requirement should unite to the requirements about backtesting in Directive 2006/49/EC, Annex V. Furthermore, it is not clear what “reporting period” means in this context. Is that referring to the capital adequacy reporting or to the frequency of the disclosure ? It would be better to say that institutions should disclose this comparison for the last 250 banking days, which is the requirement in Annex V.

Directive 2006/49

Annex 1, table 1

According to this proposal, debt securities issued by corporates which qualify for credit quality step 1, 2 or 3 gets a capital charge of 0.25%, 1.00% or 1.60% depending on residual term to maturity. Debt securities issued by institutions which qualify for credit quality step 1 and 2 gets the same capital charge. Also, debt securities issued by institutions which qualify for “credit quality step 3 under the rules for risk weighting of exposures under point 28, Part 1 Annex VI” receives the same capital

charge. The meaning of the last provision is not fully clear, but it seams that the proposed changes means that securities issued by corporates gets a more favourable treatment than securities issued by institutions. We think that securities issued by institution should be treated as least as favourable as securities issued by corporates. We also think that the provisions about securities issued by institutions should be clarified.

SECURITISATION
Potential changes with a bearing on securitisation

Substantive changes or technical amendments

The consultative document proposes a number of changes in the CRD which have a bearing on securitisation. The proposals are presented as "technical amendments", but in our view several of them are more substantive than technical in nature. This then inevitably brings up the question of how these changes fit with possible amendments to the Basel 2 Framework

From a supervisory perspective it is problematic if EU countries were to make substantive changes in the CRD with the effect that the EU rules would differ in significant aspects from the general Basel 2 Framework. Such differences would inevitably be seen as a deviation from the level playing field and bring forth calls for harmonisation from the large banking groups that are internationally active both inside and outside the EU. Swedish authorities would thus advise as a general rule that substantive changes to the CRD not be implemented unless it is known with some certainty what changes will be made to the Basel 2 Framework.

Proposed change in Article 95(2) of Directive 2006/48/EC

This proposal means that in all valid securitisations the originator will have to report a minimum of risk weighted assets of at least [15 %] even in those cases where the originator has no normal exposure or a very small one. As Swedish authorities understand this proposal it can be seen as a capital charge for the risk of implicit recourse. While there is no doubt that events during the recent turmoil have shown that this risk can be a real one, it is also a case where the EU should be vary of going alone with an improvised remedy.

- Would such a charge be effective? It would require some originators to hold more capital, but would the reputation risk not remain?
- If there is a charge, should it not cover also sponsor institutions?
- The problem is more general. There are several other structures, beside securitisation, where implicit recourse is a risk.

Proposed change in Annex V of Directive 2006/48/EC

Proposed changes in Points 3, 8 and 14 have a bearing on securitisation.

In Point 3, Swedish authorities support the addition of a new sentence to point out that the normal rules for credit granting apply also in situations where the institution intends to transfer or hedge the credit risk. However, Swedish authorities feel that the proposed new sub-point (ii) is too detailed and prescriptive. This material seems more fit for later level 3 type guidance than for inclusion in the Directive text.

With regard to Point 8, we support the proposal to mention also investors in addition to originators and sponsors. From a practical point of view, however, one might then consider just saying that "The risks arising from securitisation transactions in which the credit institutions participate shall be evaluated and addressed …"

Swedish authorities support the proposed addition to Point 14.

Proposed change in Annex VI of Directive 2006/48/EC

Swedish authorities support the principle of adding in Point 1.4.7 a sentence regarding the required commitment for an eligible ECAI to make certain summary information available with regard to the development over time of securitisation structures for which the ECAI has issued a credit assessment.

Proposed changes in Annex IX, Part 2 of Directive 2006/48/EC

The Commission here proposes the addition of new pillar 1 text that elaborates on the concept of significant risk transfer as a prerequisite for an originator credit institution to apply the capital requirements for securitisation positions retained rather than for the assets in the underlying pool of exposures. The proposal includes explicit quantitative limits.

Swedish authorities are of the opinion that this is not the best way to go. The Basel 2 Framework rules for the treatment of securitisation positions state the principle in pillar one, and then point to supervisors' pillar two powers to deal with individual institutions that can be said to misuse the system to derive unwarranted capital relief. Securitisation transactions can be structured in so many ways that it is difficult to cover all with explicit rules, and innovation continues. It is also notable that the Commissions proposed text, despite the new quantitative limits, still includes case-by-case override rules both to admit the use of the securitisation rules and to prohibit the use. The complexity of the rules is increased.

Proposed changes in Annex IX, Part 4 of Directive 2006/48/EC

Swedish authorities support the proposed changes in this Part, namely

- Removal of the preferential treatment for liquidity facilities that may be drawn only in the event of a general market disruption.
- Removal of the preferential conversion factor allowed for liquidity facilities with an original maturity of one year or less.
- Removal of the preferential 6 % risk weight for securitisation positions that belong to a tranche which is senior in all respects to some other securitisation tranche and where that other tranche is given a 7 % risk weight under the normal rules.

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