Nordea

Nordea response to public consultations on changes to capital and liquidity regulation issued by the Basel Committee and the European Commission

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Basel Committee on Banking Supervision
Secretariat, Bank for International Settlements,
CH-4002 Basel, Switzerland
baselcommittee@bis.org

European Commission
DG Internal Market and Services, Banking and
Financial Conglomerates Unit
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Dear Sirs,

We wish to inform you that Nordea welcomes the opportunity to comment on the consultative proposals to strengthen the resilience of the banking sector, as announced by the Basel Committee on 17 December 2009 as well as the consultation regarding further possible changes to the Capital Requirement Directive issued by the European Commission on 26 February 2010. Nordea concurs with the general objective to capitalise the financial system better and to reduce systemic liquidity risk. Nordea also wishes to stress that the huge endeavours undertaken by the authorities in reforming the regulatory framework deserve the support of the industry.

While overall supportive, Nordea is concerned about the impact of new regulations on Nordea's customers and the Nordic economies. The following issues in particular deserve careful consideration. First, the leverage ratio, increased capital charges on counterparty risk and countercyclical measures concerning capital requirements and the net stable funding ratio in reference to liquidity requirements may together have a strongly negative impact on the supply of credit to companies, which could harm economic growth in Nordic countries. Second, in the light of the numerous changes proposed by the Basel Committee and the Commission, a second calibrated proposal is required, including a second QIS. Third, flexibility needs to be maintained as to the timetable for implementation. The national authorities should be allowed enough time to develop countermeasures for possible negative implications on an institutional level, cf. Appendix.

Please note that Nordea's contact in this matter is Leena Mörttinen, Head of European Affairs, tel. +358 9 165 40300, e-mail: leena.morttinen@nordea.com.

Yours sincerely,

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1 General comments

Nordea supports the objective of the proposals to improve the resilience of the global financial system and to ensure a level playing field. It is indeed of utmost importance for the financial system to be better capitalised and with reduced systemic liquidity risk. Furthermore, Nordea supports the application of a robust set of prudent capital and liquidity requirements to be applied consistently and globally.

Nordea wishes to stress that the huge endeavours undertaken by the authorities in reforming the regulatory framework deserve the full support of the industry. Consequently, Nordea would like to emphasise that the comments in this document should not be construed as an attempt to fight the change but rather as an offer to share the views and proactively contribute to address the challenges together with the authorities.

The authorities are urged to give careful consideration to the revision needs so that a healthy balance is achieved between the two goals of improving financial stability and supporting economic growth. To underline this issue, in many of the points raised below Nordea has taken the perspective of its household and corporate customers in Nordea's home markets or that of the Nordic economies and markets:

1. Nordea is concerned that introduction of *leverage ratio, increased capital charges on counterparty risk* and *countercyclical measures* in respect of capital requirements and the *net stable funding ratio* as regards liquidity requirements in their proposed form could impede economic growth. These will likely severely reduce maturity transformation and market liquidity and can potentially have a clear negative effect on the supply of credit to customers in Nordic countries. Consequently, Nordea strongly supports that the authorities make a careful assessment of the impact, including macroeconomic implications. However, this analysis should be conducted not only on the level of the EU, for instance, but also for different regions such as Nordic countries and the Baltics.

2. Nordea is concerned about the speed at which the process is run. Since the proposed new regulations constitute a long list and it is likely that the proposals will need to be revised extensively Nordea is convinced that a second calibrated proposal is required, including a second QIS and a new consultative period after the aggregate impact from the first QIS is available and the revision needs become apparent. Furthermore, already before implementation, it should be ensured that the regulatory changes will not have an unjustifiably negative effect on banks with well managed risks and proven sound business models. Nordea encourages the BCBS to conduct a dialogue with the industry when calibrating the proposal before the next revised proposal is released.

3. Nordea emphasises that flexibility should be maintained as to the timetable for implementation. When the results from the QIS and assessment of macroeconomic implications in EU and e.g. Nordic and Baltic countries as a region become clearer, if the effects are deemed to be too drastic the year-end 2010 ambition for finalisation of the new regulatory framework should be postponed, or alternatively, some proposals should be deferred. The timing should be flexible enough to allow sufficient time for the national authorities to develop measures to counteract possible negative implications on an institution level as well as to reduce the likelihood of a market shock when central banks and governments are discontinuing their exceptional stimulus measures.

2 Specific comments on capital requirements

2.1 Leverage ratio

Nordea stresses that leverage ratios should be used as soft rather than hard regulatory limit and kept within Pillar II. The lack of risk-sensitivity of the ratio counteracts Nordea's efforts to steer its operations towards effective and sound risk management. Leverage ratio is too simple to be used as a measure for financial stability purposes. Nordea proposes use of the leverage ratio as an indicator among several other measures to analyse the development of the capital level and the risk of a bank. A breach of the leverage ratio constraint(s) should trigger investigation by the supervisory authorities rather than automatically compel the bank to increase its capital or divest its assets.

If the leverage ratio is implemented within Pillar I (i.e. a binding limit) *the effects on low-risk banks could be severe.* As a risk-insensitive measure it impacts low risk Nordic retail mortgage banks particularly strongly and distorts the incentives for risk management. Among other things, it does not take into account collateral available to banks engaged in mortgage lending. Implementation of such a ratio could induce retail banks to quickly reduce their lending to household customers and/or increase interest rates, and this would lead to unhealthy volatility in mortgage markets. Consequently, the impact from implementation could be more severe on banks that are already well capitalised with good through-the-cycle risk profiles. One should bear in mind that in the past crisis the capitalisation of failed global banks was too low in relation to their risks – not, however, in relation to the size of their assets.

Owing to its risk-insensitive features the introduction of the leverage ratio is likely to *create wrong risk management incentives and induce systemic instability in Nordic markets*. <u>First of all</u>, it could severely damage market liquidity of low risk instruments in the Nordic countries. The repo market, particularly in Sweden and Denmark, is very important in creating market liquidity. However, low risk repos have suffered unfavourable treatment under the current accounting rules as well as the proposed leverage ratio definition. Consequently, the Nordic repo and bond market could sustain severely damage since the new regulatory regime would provide banks with incentives to reduce their repo activities.

This could create a major systemic market disturbance. Second, institutions have incentives to increase risk-taking or to distribute the cost of the new regulatory regime to the customers. Third, leverage ratio may induce capital re-allocation, legal restructuring and increase securitisation activities. If these have no justification from a sound risk management perspective this contributes to regulatory arbitrage which is costly and impedes economic efficiency.

Instead of introducing leverage ratio, Nordea believes that authorities should improve the Basel II framework and introduce a sensible liquidity regulation. Leverage created incremental value losses during the financial crisis due to over-reliance on short term funding. Consequently, Nordea supports the BCBS work to improve the risk-sensitive Basel framework (for greater focus on activities that have proven to be inaccurately assessed) and introduce a liquidity regulatory regime. These improvements are more conducive to enhancing financial stability than leverage ratio.

2.2 Counterparty risk

Nordea does not in general support higher capital charges for OTC derivatives that are not cleared with a central counterparty, since already today there is a clear incentive to use central counterparty clearing with the current zero risk weighting (i.e. no capital requirement). It should be noted that not all customers are able to meet the requirements for central clearing of derivative contracts. For instance, many of the corporate customers lack the cash management systems necessary to engage in day-to-day margining. Consequently, punitive capital charges for bilateral and customised contracts may have a prohibitive effect through increase costs for the customers. This pushes financial risks back to the real economy as it will leave customers to bear risks they would have hedged had the costs been feasible.

Nordea understands the motivation of a specific capital charge for OTC derivatives on the risk of losses due to credit valuation adjustments (CVA) that affects the balance sheet and income statement of the institution. However, *Nordea does not support the methodology that the BCBS proposes for determining the CVA capital charge*. Institutions should have an option to use their own internal risk measures for CVA risk, not only the bond equivalent methodology that the BCBS proposes. It is also Nordea’s view that the bond equivalent method contains several elements of double-counting. For instance, the regulatory VaR multiplier already contains a time-scaling factor. It is therefore excessive to use another time-scaling factor. Furthermore, Nordea believes that the capital charge for CVA risk should be determined either as the regular VaR or the stressed VaR but not the sum of both.

2.3 Counter-cyclical measures

Overlapping counter-cyclicality proposals are a key concern for Nordea. All proposals aim to a large extent at addressing the problem of pro-cyclicality but they are not proposed to be

mutually exclusive. Nordea urges regulators to carefully assess the separate and combined impacts before calibrating the framework and before implementation.

Nordea advocates that smoothing of the minimum capital requirement be referred to Pillar II. This can be done either on the basis of a bilateral dialogue between the institution and the supervisors (as today) or as a more rule-based methodology as part of Pillar II. Irrespective of whether a principle or a rules-based approach is implemented, Nordea underlines that the downturn and average PD estimates should be possible to detach from historical data when changes in e.g. risk management practices or organisational structure warrant such an approach.

Nordea favours management of capital conservation and countercyclical buffers under Pillar II framework. Cycle-dependent capital buffers should reflect institutionally specific and local conditions, which are best managed in the supervisory review process. Nordea also opposes any new regulatory requirements that interfere with the bank's dividend policy and prohibit sound decisions by shareholders and the Board of Directors. Already today, Nordea maintains countercyclical buffers documented in the ICAAP and as a component of the capital policy.

3 Specific comments on liquidity requirements

3.1 Liquidity coverage ratio

Nordea supports the introduction of consistent and binding Liquidity Coverage Ratio (LCR), but stresses that the definition of liquid assets should be widened. In particularly, covered bonds (e.g. Danish) should be included in liquid assets. The proposed haircuts on covered bonds are too high and did not reflect the market assessment of liquidity risk of these instruments during the recent crisis. Furthermore, Nordea does not support the idea of excluding covered bonds from the stock when issued by the bank itself but not when held by another bank. Proposed run-off parameters for deposits are also overly rigid and prescriptive.

3.2 Net stable funding ratio

Nordea supports the introduction of consistent Net Stable Funding Ratio (NSFR), but stresses that the underlying scenario needs to be adjusted. The scenario in NSFR should be based on a business-as-usual assumption. Nordea does not support the current proposal, as it gives no consideration to potential adjustments that firms would make to their strategies and balance sheets during a one year stress scenario, thus imposing unrealistic parameter assumptions and would eliminate banks' ability to conduct their necessary role in maturity transformation.

Nordea is concerned about the possible market implications of NSFR. It may have drastic consequences for access to long-term funding to bank customers as well as for general market liquidity (see also section 3.5).

3.3 National options

Nordea welcomes EU Commission's proposal to remove national options and discretions and achieving full harmonisation by no longer allowing member states to apply stricter rules. Nordea does not support the BCBS proposals on national discretion ("national authorities are free to adopt arrangements that set higher levels of liquidity") as this conflicts with the principle of integrated financial markets. Nordea also welcomes the EU commission's initiatives to allow centralised liquidity risk management subject to special conditions.

3.4 Impact on monetary transmission mechanism and market liquidity

Nordea welcomes the statement indicating that before making the final proposals and calibrations, the impact of potential changes are assessed and consulted widely. However, this presents a huge challenge as the new framework is likely to have far-reaching consequences. Aside from the macroeconomic implications, the proposals are likely to have a large unintended impact on markets for various financial instruments, customers and market participants. It can further be expected that the proposals will fundamentally change the efficiency of the monetary transmission mechanism. Some of the potential consequences are briefly discussed below:

- Banks' capacity and willingness to lend will decline significantly

- Demand for assets qualified as liquid will increase (e.g. government debt). If this liquidity becomes locked up (and therefore illiquid) other assets will also be automatically considered illiquid

- Demand for securities issued by the private sector and financial institutions will decrease as there is no incentive to hold these assets. Incentives for market-making in short-term instruments will disappear. The market will lack diversity in terms of available instruments

- Pro-cyclicality will increase e.g. spill-over effects due to credit downgrades of liquid assets. Risk of contagion from liquidity disclosures increases

- Maturity transformation conducted by banks will be reduced leading to major reduction in money creation and hampering prospects for economic growth Increased incentives for regulatory arbitrage as other market players outside the supervisory framework will try to assume banks' role in maturity transformation

- Funding costs for banks will rise substantially, increasing significantly the price for customers

- Pricing of customer deposits follow the given rigid segmentations and the flexibility to design new products will be reduced

- Monetary policy will become less effective as short-term borrowing and interbank markets will decrease significantly. Libor rates will be affected and will become less informative and robust.

4 Implementation of regulation – group vs. legal entity

Nordea stresses that leverage ratio and counter-cyclicality measures proposed in the new capital requirements, if implemented, should be applied only on a groupwide level. Cascading these to lower levels would most certainly mean excessive capital requirements on group level. If leverage ratio is not kept within Pillar II or if the supervisors interpret the threshold as a hard threshold (although within Pillar II), this will have a very large impact on the structure of many banks and induce market fragmentation that opposes the EU single markets principle. Leverage ratios for subsidiaries within a financial group of companies can differ substantially and e.g. Nordea is active in 9 markets. To even out these differences exposures and/or capital would have to be allocated throughout the group. Forced allocation is inefficient and will distort a level playing field and is likely to affect some financial groups more negatively than others. The legal structural set-up can be threatened, when implementing the risk-insensitive leverage ratio for separate entities within a group.[1]

Nordea stresses that the BCBS framework for liquidity risk management should be applied on a group level. At the moment the level of application of the BCBS framework is not clear. This is a particular concern for Nordea which has operated efficiently on a centrally managed liquidity model. Nordea welcomes the EU Commission's initiatives to clarify the issue giving opportunity to centralised liquidity risk management when special conditions are met. Nordea strongly believes that centralised liquidity risk management should be allowed within a consolidated legal group, when there are legally binding mutual commitments for liquidity support between the relevant entities and assets are freely transferable between legal entities. Without this waiver trapped pools of liquidity and double counting of liquidity risk could occur if there is an asymmetry of treatment of intra-group exposures, leading to an inefficient use of liquidity and thereafter reduced liquidity in the economy. This would also be in conflict with the EU single-market principle.

5 Systemic risks and systemically important financial institutions[2]

[1] For example, many Nordic banks have most of their mortgage portfolios within separate legal entities. These entities can have a relatively high leverage due to relatively low risk inherent in Nordic mortgage lending.

[2] Discussion on systemic relevance is specifically a response to questions in the Commission Services Staff CRD IV Working Document on the most appropriate means of measuring and addressing systemic importance and how to ensure consistent prudential treatment of systemic importance across financial sectors and markets.

Since clear and objective proxies for defining systemically important financial institutions (SIFIs) that take into account the changing nature of systemic risk are difficult to find, Nordea remains sceptical to the usefulness of such definitions. It must be pointed out that the concept “systemically important” may not make any sense at all since in the crisis small institutions could also become systemically relevant. Furthermore, many small institutions with no systemic relevance will be bailed out owing to political pressure. In general, size in itself says nothing about the risk profile of an institution. There is in fact empirical evidence available suggesting the existence of an inverse relationship between size and the probability of a financial institution defaulting owing to diversification benefits. Any identification method used for SIFIs will likely result in a list of institutions being formed. This would increase the moral hazard on the one hand while inducing regulatory arbitrage on the other.

Nordea emphasises that definitions of systemic importance across financial sectors are not likely to reduce systemic risk - they will only change the way risk is transferred through the system. Flexible macro-prudential monitoring of interconnections within the financial system is the most useful tool for assessing financial market fragilities. The European Systemic Risk Board should be given adequate powers to monitor, assess and take action if system-wide fragilities start to emerge. Furthermore, many of the proposed measures to increase the level and quality of capital and to improve liquidity risk management, after satisfactory testing (including second QIS) and adjustments based on their macroeconomic implications, will already reduce systemic risk in financial markets. These should be further complemented with harmonised crisis management tools reducing moral hazard in the financial system.

6 Interactions between different proposals

Liquidity requirements vs. leverage ratio: Liquidity risk management may force institutions to invest in liquid marketable assets in order to meet the new regulatory regime. However, the leverage ratio requirement contradicts these measures as liquidity assets are not excluded from the definition of the leverage ratio.

Increased need to issue common equity vs. reduced investor appetite for bank equity: The new regulatory proposals may reduce return on equity (ROE) significantly since they induce banks to issue more common shares. The question remains, whether investors are willing to invest in bank equity with the revised ROE expectations. Consequently, regulation could at the same time increase the supply but reduce the investor’s demand for equity.

Overlapping counter-cyclicality measures: In reference to interactions between different counter-cyclical measures, authorities are urged to carefully assess the combined effects to avoid double-counting and excessively punitive effects from being realised.

CCP cleared vs. non-CCP cleared contracts: the zero risk weighting already creates clear incentives to use CCPs, additional capital charges for contracts that are not CCP cleared are in general unnecessarily punitive.