

Annex: Detailed DK response to the Commission consultation

As a general comment on this consultation, we would like to draw attention to the enclosed letter made by the Danish Minister for Business, Industry and Financial Affairs, Mr. Simon Kollerup, addressed to Executive Vice-President for An Economy that Works for People and Commissioner for Financial Services, Financial Stability and Capital Markets Union, Mr. Valdis Dombrovskis.

Credit risk

1.1. Standardised approach (SA-CR)

1.1.1. General issues

1.1.1.1. *External credit risk assessment approach (ECRA) vs. standardised credit assessment approach (SCRA)*

In general, we support using External Credit Risk Assessments for sovereigns, public sector entities, multilateral development banks, institutions, covered bonds and corporates.

1.1.1.2. Enhanced due diligence requirements

Overall, we agree with the due diligence requirements in the Basel III standards. However, we do not find that it is necessary to introduce changes to the current due diligence requirements in the CRR and CRD as the current EU regulation on due diligence encompasses the Basel definition.

1.1.2 Exposures to institutions

1.1.2.1. Definition of grades under SCRA

Overall, we support the SCRA for exposures to unrated institutions introduced by the Basel III standards as it increases the risk-sensitivity. However, we find that further clarifications are necessary. We support that minimum capital and buffer requirements beyond the Basel minima should be taken into account for the classification of grades, where the requirements are implemented in the jurisdiction of the counterparty institution. Therefore, we support that it should be clarified that institutions should satisfy capital requirements under Pillar 1 and Pillar 2 as well as relevant capital buffers to be classified as grade A under SCRA.

Furthermore, in the Basel III standards, a lower risk weight of 30% can be assigned for exposures to unrated institutions under SCRA when the counterparty institution e.g. has a CET1 ratio that exceeds a threshold of 14%. This criterion should be adjusted to reflect the excess CET1 ratio relative to the minimum capital requirements in order to sufficiently capture the risks of these exposures since institution's Pillar 2 capital requirements and buffers generally differ across institutions.

1.1.2.2. Identification of short-term exposures to institutions

We prefer to identify short-term interbank exposures based on the residual maturity of the exposures. Institutions use this approach consistent with the current CRR. Introducing a different approach could require changes in IT systems and an increase in administrative costs for the institutions. This is not justified based on the limited impact a change from residual maturity to original maturity is expected to have.

1.1.3. Exposures to corporate

1.1.3.1. Treatment of unrated corporates

In some jurisdictions, external ratings of companies are not common. Under the ECRA, these jurisdictions will therefore generally assign a flat risk weight of 100% to non-SME corporate exposures, regardless of the underlying risks of the exposures. This is not sufficiently risk-sensitive.

This is the case in Denmark. Only the largest companies have an external rating in Denmark. For instance, all but one of the Mid Cap segment listed on Nasdaq Copenhagen does not have a rating. Companies in the Mid Cap segment have a market value between EUR 150 million and EUR 1 billion.

In our view, a better risk sensitivity will be achieved by allowing a combination of ECRA and SCRA for the treatment of unrated corporate exposures that do not qualify as SMEs. More specifically, we suggest that rated corporate exposures should be risk-weighted based on ECRA while unrated corporate exposures should be risk-weighted based on SCRA, except for exposures to corporate SMEs.

In our view, this approach is prudent and increases the risk-sensitivity of the risk-weighted treatment of exposures to unrated non-SME corporates.

In addition, we recommend removing the requirement of outstanding securities on a recognised exchange in the definition of investment grade or introduce this requirement as a supervisory discretion. In some jurisdictions, it is more common for companies to finance through bank loans rather than issuing securities. These companies will not fulfill the criteria of investment grade corporates even though they have as high a creditworthiness.

This approach is not risk-based. In our view, the classification of investment grade should be based on the underlying credit risks of the exposures and not by national specificities.

We find that the definition of investment grade should be further clarified and be more comparable across institutions. The definition should also ensure that only exposures with a sufficient creditworthiness could be classified as investment grade.

In this context, we recommend clarifying that an investment grade is generally equivalent to an external rating of BBB- or better. This is the investment grade definition used by rating agencies as S&P and Fitch.

Similarly, the definition could include a threshold for probability of default calculated internally in the institutions, which would constitute investment grade. This will most likely be the approach for many institutions using advanced internal credit models, and defining a threshold would limit variability in the exposures defined as investment grade.

Furthermore, it could be added that institutions must perform due diligence of investment grade corporate exposures to ensure that institutions have an adequate understanding of the risk profile and characteristics of these exposures.

1.1.4. Equity and other capital instruments

1.1.4.1. Standard treatment of equity exposures

We support the increase in risk weights for equity exposures and subordinated debt exposures in the Basel III standards. Equity exposures should have a higher risk weight than simple loans to unrated corporates and subordinated debt exposures should have higher risk weight than the loans that are senior to these exposures.

Regarding subordinated debt, we find it important to specify that this should also include non-preferred senior debt in line with other TLAC liabilities meeting the requirement in the BCBS TLAC holdings standard.

1.1.4.2. Treatment of 'speculative unlisted equity exposures'

We believe that introducing a higher risk weight for speculative investments in unlisted equity is prudent. However, we do not agree that private equity should automatically be categorised as speculative and thus have a higher risk weight. Private equity of corporate exposures with which the bank has or intends to establish a long-term business relationship with should not be categorised as speculative as described in footnote 30 of the Basel III standards.

Private equity of corporate exposures with which the bank has or intends to establish a long-term business relationship would then be classified as equity and if deemed not speculative risk-weighted 250% compared to the 100% today according to the guideline on high risk items.

Regarding subordinated debt, we find it important to specify that this should also include non-preferred senior debt in line with other TLAC liabilities meeting the requirement in the BCBS TLAC holdings standard.

1.1.5. Retail exposures

1.1.5.1. Notion of 'transactors' and 'other retail'

We welcome the introduction of transactors under regulatory retail exposures in the Basel III standards. We believe that the treatment of exposures under transactors prudently reflect the risks of these exposures and enhances the risk-sensitivity of regulatory retail exposures.

1.1.5.2. 'Granularity criterion' and additional measures to ensure diversification

We do not support the granularity criterion introduced by the Basel III standards where no aggregated exposure to one counterparty can exceed

0.2% of the overall regulatory retail portfolio. In our view, this criterion creates an unlevel playing field for the smallest institutions solely based on their size.

We therefore support to maintain the granularity criterion in the current CRR to ensure diversification for regulatory retail exposures. We also welcome further guidance that is simple and operational without creating an unlevel playing field for the smallest institutions.

1.1.6. Real estate exposures

1.1.6.1. Implementation of loan splitting (LS) approach vs whole loan (WL) approach

We support the loan splitting approach in the Basel III standards. In our view this approach is prudent and takes the risk of the counterparty into account for the part of the exposure that is not secured. However, we do not believe that the loan-to-value (LTV) and the corresponding risk weights, for in particular residential property, are calibrated to take into account the European real estate market in the loan splitting approach. We therefore suggest introducing an additional LTV tranche in the loan splitting approach.

More specifically, we propose a risk weight of 20% to the part of the exposure within a LTV of 55% and the counterparty's risk weight to the part of the exposure that exceeds a LTV of 80%. This is similar to the Basel III standard. However, we propose to introduce a risk weight of 35% to the part of the exposure with a LTV between 55% and 80%.

1.1.6.2. Treatment of exposures where the servicing of the loan materially depends on the cash flows generated by a portfolio of properties owned by the borrower

We see the rationale behind the portfolio criterion for Income Producing Real Estate. If the borrowers ability to repay the loan depends on multiple properties aside from the property associated with the loan, there is an increased risk that the ability to repay and the value of the property and hence the mortgage would be sensitive to the same types of risk drivers.

In this situation, the standard real estate approach towards risk-weighting would underestimate the inherent risk of the exposure. We acknowledge

that this as a potential issue, but we do not expect it to have a significant impact on the overall risk. We would therefore suggest including the option as an alternative approach to be applied at supervisory discretion on a caseby-case basis.

1.1.6.3. Eligibility of property under construction

We support implementing a preferential treatment for certain properties under construction where the borrower will be the primary resident of the property. The threshold of one-to-four housing units seems appropriate.

1.1.6.4. Prudently conservative valuation criteria

The CRR defines the current valuations methods 'market value' and 'mortgage lending value' by quite specific requirements. Both market value and mortgage lending value is governed by international valuation standards, and the use of mortgage lending value require for Member States to have laid down rigorous criteria for the use of this methodology. Both methodologies represent well-established practices and the use and performance can be monitored and calibrated to a comprehensive amount of data accumulated for a long period.

Market value and mortgage lending value share some characteristic, but differ in others. Market value intends to establish an informed expectation as to the price for something, one that is neutral as between buyer and seller and is universally understood as representing a market assessment of value at a given point in time, where the mortgage lending value require an assessment of the future marketability of the property taking into account long-term sustainable aspects of the property. Both of them however aims at establishing a value that is prudent to use for capital requirement purposes.

The Basel III standards set the market value as a ceiling for the 'property value'. We consider this a sensible approach to ensure that the current use of the well-established practices can be encompassed in a new definition a definition including the additional requirements to exclude expectations on price increases and for the value to be adjusted to take into account the potential for the current market price to be significantly above the value that would be sustainable over the life of the loan.

Following this, we see the merit in implementing the general valuation criteria in paragraph 62 in the Basel III to harmonise the value of real estate as collateral in Union legislation and to require a more prudent approach in that respect.

As the definition of 'property value' in the revised Basel III does not contain specific methodologies or approaches to valuation, this shall be considered when implementing the new definition.

Replacing two different valuation methodologies with a new definition will in any case lead to transitional costs. It is therefore of utmost importance that the new methodology is clearly defined, including how valuation is supposed to be carried out to meet the requirements of a new definition to ensure a smooth transition.

To avoid unnecessary operational burdens the introduction of a new valuation requirement shall as mentioned consider the current well-established practices.

Further, the use of the existing valuation methodologies in existing Union legislation will need to be taken into account and changed if necessary. This includes the Covered Bonds Directive, which require eligible collateral to be valued by using either market value or mortgage lending value.

We consider it of vital importance to ensure a very clear level 1 text to set the overall requirement for property value. The level 1 text should also include the requirement for national supervisors should provide guidance setting out prudent valuation criteria where such guidance does not already exist under national law as suggested in Basel III.

The overall requirement for using property value as the basis should be based on a thorough analysis of how this should be carried out in the Member States. This assessment work should preferably be undertaken on a specialist level under the EBA before the finalisation of the implementing legislation.

The current Article 208 of the CRR requires ongoing monitoring and revaluation of immovable property to qualify as eligible collateral. This monitoring and revaluation shall ensure decreases as well as increases in the value to be reflected in the valuation, as defined in Article 229 of the CRR where it is required that 'The value of the collateral shall be the market value or mortgage lending value reduced as appropriate to reflect the results of the monitoring required under Article 208(3) (...)'. We consider this an important element in ensuring a prudent and accurate approach in relation to valuation of real estate.

If a different valuation methodology is introduced as part of the implementation of the Basel III standards the monitoring and revaluation requirement should be kept.

The EBA 'Policy advice on the Basel III reforms: credit risk' state in point 182 that 'market values can always decrease, thus an MV concept cannot meet the requirement to take into account the potential for the current market price to be significantly above the value that would be sustainable over the life of the loan. It is therefore impossible to ensure that.'

We cannot support this understanding and will advise against having this approach reflected in the implementation of the valuation requirement from Basel III.

The value of the property can increase and decrease for properties valued under the market value approach as well as the mortgage lending value approach. No valuation methodology can protect against market fluctuations.

To ensure a prudent approach to valuation and to take market fluctuations into consideration, we consider the ongoing monitoring and revaluation as described above to be the appropriate way forward.

1.1.6.5. (Re-)valutation at origination vs. current value

We support that the value of properties should reflect current value and therefore should not be capped at the property value measured at loan origination. In our view, using the current value of the properties reflect the actual risk of these exposures. In addition, the monitoring requirements of the property values and the prudently valuation criteria ensure a prudent valuation and mitigate possible cyclical effects.

1.1.6.6. Land acquisition, development and construction (ADC) exposures – general treatment

We generally support replacing the current treatment of speculative immovable property financing with the Basel III treatment of ADC exposures. However, we do not believe that the Basel III is sufficiently clear for exposures, where the borrower buys a finished property with the intention of reselling the property with a profit. These exposures are risk-weighted 150% under Article 128 of the CRR. We believe that this is prudent and should be maintained when implementing the Basel III in the EU.

1.1.6.6. ADC exposures – conditions for the application of 100% RW

ADC exposures can receive a lower risk weight when certain criteria are satisfied. We support having clear quantitative thresholds of the necessary amounts of cash deposits and/or equity at risk needed for the exposure to receive this preferential treatment to ensure a harmonised application.

1.1.7 RW multiplier to certain exposures with currency mismatch

We see the rationale behind a risk weight multiplier for exposures with currency mismatch. These exposures are subject to higher risk compared with exposure where the borrower's income and the exposure is denominated in the same currency and the exchange rates are floating. However, where there is limited or no actual exchange rate risk, as in the case of Danish kroner and the euro given the ERM 2, the risk weight multiplier would not be justified. Such arrangements should be taken into account.

1.1.8. Off-balance sheet (OBS) items

1.1.8.1. Definition of commitment

In our view, the Basel definition of off-balance sheet exposures is already implemented in the CRR and the current application. If the Basel definition of commitment should be incorporated in the current legal text, we would deem it important to not chance the current scope of which exposures constitute an off-balance sheet item.

1.1.8.2. New credit conversion factors (CCF)

We support the credit conversion factors (CCF) for off-balance sheet exposures introduced by the Basel III standards. In particular, we support a CCF of 10% for unconditionally cancellable commitments instead of the 0% defined in the current CRR. We do not find that a CCF of 0% reflects the underlying risks in these exposures.

We see the prudential rationale behind the national discretion in footnote 30 of the Basel text. We agree that the type of arrangements fulfilling all the criteria would be far less risky than a credit for example. While we do not from our perspective see the need for the discretion, we would be supportive of introducing it if evidence of its relevance was tabled.

1.2. Internal Rating Based approaches (IRBA)

1.2.1. Reduction of the scope of internal modelling

Question 62

By and large, we support the proposed changes to the IRB approach. In combination with the substantial work carried out by the EBA in the IRB area, these changes go a long way in achieving the goal of reducing unwarranted RWA variability.

We find that the changes strike an appropriate balance between maintaining risk-sensitive capital requirements and mitigating the problems associated with unwarranted RWA variability. This is also one of the main reasons behind our skepticism towards the output floor, cf. questions 177-187.

Specifically with respect to the reduction in scope of internal modelling, we consider the proposed changes to be appropriate. Indeed, experience shows that the affected portfolios are inherently difficult to model and, hence, a major driver of RWA variability. To disallow the use of AIRBA for these portfolios could contribute to more robust RWA without severe implications for risk management.

1.2.3. LGD – input floors under AIRBA

Question 69

Moving from portfolio-level to exposure-level LGD input floors constitutes a major change. In our view, this is a significant contribution to achieving the goal of reduced RWA variability.

The floor will have a significant impact on low risk portfolios, such as residential mortgages. We do, however, find the measure to be balanced as

it generally continues to allow risk-sensitive capital requirements. At the same time, significant safeguards are put in place. This may be particularly useful in times of benign economic conditions where capital requirements may otherwise drop to excessively low levels.

Question 70 See question 69.

1.2.6. EAD – Scope of modelling

Question 79

A general issue for CCF modelling is that the data can be scarce. In addition, modelling practices are not well developed in this area. Hence, limiting the scope of EAD modelling does not have adverse implications for risk management.

Thus, we find the restrictions appropriate. In our view, this will contribute to achieving the goal of reduced RWA variability.

1.2.7. EAD – regulatory CCF values

Question 82

We support the alignment of the definitions. Further, we also support the change in CCF for unconditionally cancellable commitments to 10 % instead of the 0 % defined in the current CRR. We do not find that a CCF of 0% reflects the underlying risks in these exposures.

1.2.11. Additional enhancements of IRB risk parameter estimation practices

Question 92

The EBA has already published extensive guidelines and technical standards in the IRB area. These products have triggered substantial redevelopment of IRB models across Europe and the results of this work still remain to be seen. In combination with the changes triggered by Basel III we do not see need for further measures.

1.3. Credit risk mitigation - SA-CR

We support the changes Basel introduces to this framework, and we suggest full Basel compliance regarding the implementation.

1.4. Credit risk mitigation – IRBA

1.4.1. Unfunded credit protection (UFCP) – the treatment of AIRB exposures secured by SA-CR or FIRB guarantors

Question 105

We find risk weight substitution for AIRB when the guarantor is treated under (FIRB or) SA-CR as a very appropriate approach to account for UFCP. It is relatively simple and transparent approach in terms of both operational burden and comparability. Further, we see no material issues in regards to risk-sensitivity.

1.4.2. UFCP – relevant risk weight function and input floors to be used under the substitution approach

<u>*Question 107*</u> See the answer to question 105.

1.4.5. Implementation challenges and administrative burden

We do not see the changes as particularly challenging to implement.

Securities financing transactions

2.1 Minimum haircut floors for certain SFTs

The incentives provided in the framework may not be sufficient to encourage the institutions to meet the minimum level of overcollateralization. There is a risk that framework may cause more uncollateralized transactions. This is because if the SFT transactions does not fulfill the minimum haircut floor then the collateral exchanged is not recognized which as regards REA is the same as not exchanging any collateral at all. The institution might therefore just provide an unsecured loan to the counterparty which would be applied the same capital requirement.

In general, we would deem further clarification necessary. For example a clear definition of what is considered a SFT is needed in order to implement the correct scope.

As regards to the regulation, the implementation of minimum haircut floors should be performed through market regulation as the original purpose of the minimum haircut floor is to decrease shadow banking risk on the SFT market. If it is chosen to implement through an entity based regulation then any consistency between the SFT regulation and other regulation should be ensured.

2.3. Implementation challenges and administrative burden

We have currently not detected any additional challenges and administrative burdens to be raised.

Operational risk

3.1. Discretion to set the ILM equal to 1

We find that exercising the discretion and set the ILM to 1 could imply a less risk sensitive capital requirement and reward institutions with high operational losses relatively to similar institutions with lower losses. Furthermore, neutralizing the ILM may give institutions less incentives to collect loss data and build up a structural and comprehensive database. The inclusion of the ILM would contribute to increased attention to sound operational risk management, as the operational risk events affects the capital requirements.

3.2. Discretion to increase the loss data threshold to EUR 100,000

We believe that the use of the discretion may require an in-depth assessment of the institutions loss data history for example to avoid non-collection of loss events with the same root cause but losses in different periods (as law suits). Even though a higher threshold in some cases may increase the ILM, we believe, that the loss data threshold should remain at 20.000 to maintain a level playing field.

3.3. Discretion to use the ILM for bucket 1 institutions

To incentivise loss data collection for bucket 1 institutions, these should be granted permission to use the ILM upon a supervisory approval. However, when granting the permission, the framework should require ILM above 1 for a time period defined by the framework to make sure the institution fulfill the qualitative and quantitative requirements for using the ILM.

3.4. Discretion to request institutions to use less than five years when the ILM is greater than 1

We welcome flexibility in the framework to allow institutions to use the ILM even though the loss data period is less than five years when the ILM

is greater than 1. This provision could be useful for institutions that move from bucket 1 to 2 or for bucket 1 banks applying for ILM. However, to seek consistency in the competent authorities treatment of such application, the framework need further clarification.

3.5 Exclusion of certain operational risk loss events

Tail loss events should not be excluded in the calculation of the ILM before risk-mitigation actions are implemented and operated for at least two years and duly tested. Mitigation actions and test results should be documented and approved by the competent authority. Excluded loss events should remain in the loss dataset but neutralized when calculation ILM, and may be considered in the assessments of pillar II requirements.

3.6. Other operational risk topics

To achieve a level playing field and same operational risk standards across the union, we welcome both expansion of current requirements as well as inclusion of additional requirements on operational risk governance and treatment of loss data in level 1 and level 2 text. Some core governance and loss data requirements should be applicable for all institutions and more comprehensive requirements for large and medium sized bucket 1 and bucket 2 and 3. Any threshold should be based on the BI-component.

3.6.2. ICAAP and Pillar II

Internal loss data, scenario analysis, external loss data and key risk indicators among others should be included in assessment of pillar II requirements for operational risk. However, such quantitative analysis should not substitute but rather complement qualitative assessments of e.g. governance setup, adequacy of control systems, risk and compliance management.

3.7. Other provisions

We have currently not detected any other issues to be raised.

<u>Market risk</u>

4.1. Converting the reporting requirement into an own funds requirement

In general we support converting the own funds reporting requirements into own funds requirements when implementing the Basel III in CRR III.

4.2. Introduction of the simplified standardised approach

We welcome the introduction of a simplified standardized approach since it will be an unnecessary burden for institutions with limited market risk to compute their capital requirement via the sensitivity based SA. When calibrating the simplified approach we believe that it is important to

ensure that the model is sufficiently prudent to compensate for the lower risk sensitivity compared to SA.

4.4. Date of application of new own funds requirements for market risk

The date of application should in general be as soon as possible after the implementation of the framework. However to avoid possible cliff effects, the experience from the data received from the reporting requirements should be assessed.

4.5. Other provisions

We have currently not detected any other issues to be raised.

4.6. Implementation challenges and administrative burden

We have currently not detected any additional challenges and administrative burdens to be raised.

Credit valuation adjustment (CVA) risk

5.1. Revised CVA framework

We support the introduction of a more risk sensitive framework compared to the current framework as the SA-CVA introduces more risk sensitivity compared to A-CVA.

As regards to transactions that may be particularly affected by the implementation of the revised framework, we find that the inclusion of SFT into the scope of CVA does suggest that the SFTs especially will be affected by this.

5.2. Exemptions under the CRR

We welcome a reassessment of the exempted counterparties.

In general, and due to the high risk stemming from exempted counterparties, the exemption should be modified. The impact of removal of the exemptions of non-financial counterparties on the RWA is expected to be significant, reflecting that the risk is currently understated. Thus this exemption should be removed.

The removal of the pension fund exemption would increase the need for the pension funds and banks to exchange variation margin and not just initial margin in order to mitigate the CVA risk. This would increase an unintentional burden on the pension funds, as these according to EMIR would need to hold cash, which is in contrast to the purpose of the pension funds. Thus this exemption should be kept.

Because of the disincentive from the exemption very few institutions choose to hedge the risk stemming from exempted counterparties. Instead most institutions only apply a small pillar II requirement. An institution that decides to hedge the exposure deriving from exempt counterparties in the current framework does not get these hedges recognized, and the institution is therefore required to hold capital against these hedges under the market risk framework, even though the risk is fully neutralized by actual CVA positions from the exempt counterparties. Not recognizing the hedges cause to two challenges i) it reduces the incentive to mitigate this non-capitalized risk and ii) the hedges may reduce the market risk capital requirement if the hedges is directionally opposite the risk derived from the trading book. Regardless of the treatment of the exempted counterparties, the hedges should be recognized.

5.3. Proportionality in the CVA framework

The current threshold at EUR 100 billion for institutions to use the simplified approach is appropriate.

For institutions with a smaller derivative portfolio and for whom the CVA risk is insignificant the burden of calculating the CVA risk charge is relatively large. For these institutions a simple multiplier applied to the own funds requirement for counterparty credit risk may be considered.

5.4. Internal CVA under the SA-CVA

The principal based definition of internal CVA sensitivities is appropriate. We do not see a possible alignment with the accounting CVA even though this would reduce the operational burden, as the definition of internal CVA is built upon the assumption of risk neutrality which is appropriate for risk measures.

In the supervisor permission process the operational burden on the competent authorities will increase as an approval of IMM and SA-CVA under the new framework cannot be combined. It should be considered if the framework shall be adjusted so that an approved IMM model which fulfills the requirements can be used as an underlying exposure model for the SA-CVA.

5.5. Fair-value SFTs under the CVA framework

In general is the inclusion of the SFTs into the scope of the CVA framework not considered to be burden full. However, there might be an issues if only the fair value SFTs are included, as this induces incentives to hold SFTs to amortized cost instead of fair value. This issues should be considered.

5.6. Other provisions

There framework should ensure consistency with the market risk regime in calibrating the correlation parameter between buckets for currencies under the ERM II regime and the definition of liquid currencies.

5.7. Implementation challenges and administrative burden

We have not detected any additional implementation challenges or administrative burdens.

Output floor (OF)

6.1 Material scope of application

Question 177

As also mentioned under question 62, we find that the proposed changes regarding the IRB approach in combination with the substantial work carried out by the EBA go a long way in achieving the goal of reducing unwarranted RWA variability.

We therefore question the need for an output floor altogether.

Our primary concern in this regard is the loss of risk sensitivity associated with the output floor. Risk sensitive capital requirements ensure that capital is allocated to the banks/portfolios where it is most needed to absorb risk. Conversely, lack of risk sensitivity gives banks inappropriate incentives. Banks bound by the output floor will have an incentive to take on more risk since the increased risk taking is not associated with increased capital requirements.

Impact studies, including the EBA's advice to the Commission, show that many European banks will be bound by the output floor. This includes most Danish banks. Indeed, the main suggestions in the EBA's report will effectively result in the IRB approach being replaced by the output floor for the majority of the Danish banking market.

Hence, the abovementioned problems are far from hypothetical and we have serious concerns about the output floor and the implications for the Danish market.

Our preferred solution is to abandon the output floor altogether. Notwithstanding this, we will of course take a constructive approach and consider other options as well.

We have outlined different potential ways to mitigate the problems in our answer to this question as well as under questions 178 and 185 below. Some of the proposals can be combined. We will be very happy to discuss with the Commission and to elaborate further.

Regarding the specific question, it follows from the reasoning above that we are opposed to extending the output floor requirements beyond those that are explicitly mentioned in the Basel III standards.

Indeed, we find that some of the adverse consequences of an output floor can be mitigated by considering two parallel requirements:

- 1. A risk based requirement where all capital requirements (including EU specific requirements) are calculated based on RWA from internal models.
- 2. An output floor requirement where capital requirements mentioned in the Basel text are calculated based on RWA from the output floor.

The final capital requirement would then be the larger of the two requirements above.

Such an approach would help ensure that the output floor acts as a true backstop instead of replacing internal models altogether. We consider the approach to be fully Basel-compliant. Indeed, it subjects EU banks to the same requirements as non-EU banks located in countries which follows the Basel standards.

Question 178

The output floor is particularly punitive towards low risk portfolios such as residential mortgages. This is especially relevant in a European context since banks in the EU tend to keep the vast majority of the residential mortgages which they originate on-balance. By contrast, securitization is far more common outside the EU.

Also, the riskiness of residential mortgages is lower in the EU than in many other jurisdictions. This is certainly true for the Danish market which has a long history of very low losses on residential mortgages. This can be attributed to risk reducing features such as full recourse and efficient liquidation processes.

Based on these considerations, we find there is a strong case for allowing a preferential treatment for residential mortgages in relation to the output floor. This could, for example, be in the form of a complete exemption from the output floor. Alternatively, residential mortgages could be subject to a lower output floor than 72.5%.

Such preferential treatment could potentially be subject to certain qualifying criteria. For example, the preferential treatment could be limited to markets with a history of demonstrably low losses.

6.4 Other provisions

Question 185

As described under questions 177 and 178, we are concerned about the consequences of an output floor and we have outlined possible solutions. We believe there are also other solutions that could be consiered. These include a different calibration of the output floor and a permanent cap over

the RWA increase due to the output floor. We will be very happy to discuss with the Commission and to elaborate further.

Centralised supervisory reporting and pillar 3 disclosures

Question 189.1

Denmark supports transparency in banks and welcomes increased comparability across the sector. As such a central disclosure hub administrated by the EBA would further promote transparency in the sector.

Question 189.2

Denmark supports a single location policy for all institutions both large and small. However, the burden of the obligation for small institutions should be minimized as much as possible.

Question 189.3

The responsibilities for the information should be connected to the responsibilities of the involved entities. Therefore the responsibility of reporting the correct information should be with the institution. If something delays disclosure which is caused by the EBA or the competent authority then these will bear the responsibility for the delay. The same should be the case if for some reason the data disclosed is different from the data reported by the institution and the difference is due to an error by the EBA or the competent authority.

The competent authority should continue to supervise the data disclosed according to a risk-based approach.

Sustainable finance

In the context of the last CRD5/CRR2 review, a number of initiatives in relation to the incorporation of ESG risks into prudential regulation were agreed upon. The Danish FSA appraise that these initiatives should be awaited before initiating additional measures. Hence, for now the Danish FSA do not identify any additional measures, which can be taken to incorporate ESG risks into prudential regulation.

Fit and proper

9.1. Key function holders

Question 192

According to Section 64c of the Danish Financial Business Act (FBA), all credit institutions shall identify its key function holders. This includes, inter alia,

- the head of the risk management function
- the head of the compliance function
- the head of the internal audit function
- the head of the credit area,
- the person in charge of AM
- other members of the actual management with reposnibility for AML and compliance

The DFSA must assess each key function holder as fit & proper in accordance with FBA section 64, which is the general fit & proper regulation. Key function holders must submit information to the DFSA in order for the DFSA to be able to assess the person's fitness and propriety on the parameters mentioned in Section 64(1).

The aim of the rule, which entered into force in the summer of 2019, is to ensure a high level of competencies and personal integrity for key function holders of all banks (the requirement was previously only for SIFIs).

As the rule has only been in existence a few months, it is too early to evaluate the results. However, we believe that the pros (stronger management of credit institutions and regulatory convergence) should on balance outweigh the cons, which include a further increase in fit & proper assessments, (initial) regulatory uncertainty (see below) and a further intervention in the management of financial companies.

Question 193 Yes.

Question 193.1

The introduction of the rule in Danish legislation has given rise to some confusion among smaller credit institutions in particular. The DFSA has seen a big variety in which roles are included among the key function holders – and further guidance is needed – if not in the CRD, we would have to do it ourselves.

Question 194

The Danish FBA mentions the following roles:

- the head of the risk management function
- \circ the head of the compliance function
- \circ the head of the internal audit function
- the head of the credit area,
- \circ the person in charge of AM

We believe these roles to be crucial within a credit institution.

Question 195

In Denmark, the requirement of fit & proper assessments of key function holders applies at the level of each institution.

Question 196

The criteria should be (and are in Denmark) the same as other fit & proper assessments. Hence proper is an absolute where integrity, good repute etc is needed in all roles. Fitness should be assessed vis-à-vis the specific role in the specific institution. Proportionality is key once institutions other than SIFIs are considered. Some roles require specific experience and knowledge (e.g. AML, credit) while others require a broad understanding of the institution in question but not necessarily experience from specific functions. The DFSA is currently developing more specific requirements in regards of experience and competencies for various key function holders.

9.2. Competent authorities' assessment of the suitability of members of the management body

9.2.1. Supervisory procedure

9.2.1.1. Ex ante and ex post approval and ex post notification

Question 197

The two main considerations for the DFSA are the risk of a person starting in a position that they will subsequently be deemed not suitable for and having to step down (which would argue for ex-ante approval) vis-à-vis the delay in starting a new position (which would argue for ex-post approval). The DFSA experiences that more and more institutions ask for ex-ante approval – which puts pressure on the processes of the DFSA.

Question 198

In Denmark, both ex post and ex ante are possible. The main problem with ex ante seems to be the delay for the institution in question and the consequent pressure on the DFSA to assess quickly.

Question 199

This is a real problem as it relates to members of the board in its management function, due to a combination of

- A. a (perceived?) increase in "fit" requirements
- B. a larger focus in reputational risks when appointing new members of the board, who could be tainted by previous work experience

Several large Danish financial companies have experienced problems recently in appointing new CEOs among other things.

Succession planning becomes more important as fit & proper rules and practices are tightened and worries over reputational risks increase. The DFSA thus believes that succession planning could become a specific requirement in financial regulation.

Question 200

We are not convinced that any roles need to be assessed ex ante. Should a financial institution feel a need to hire someone and seek approval ex post, they run the risk of a negative assessment.

Question 201

In most cases, this would be unproblematic – of the more than 1000 fit & proper assessments the DFSA carries out annually, most are smooth and quick. However, in some instances deadlines would not be able to be meet if the person in question has been involved in a case which requires further analysis, As fit & proper rejections are very intrusive supervisory reactions, there is a strong need to ensure a thorough treatment of such cases.

Question 202 No

Question 202.1

Everybody has an interest in such cases being settled as quickly as possible. Time limits may be problematic for the reasons set out above – but not if ex post approval is possible.

Question 203

The DFSA believes as a principle that it would always be preferable for a decision to be issued to ensure clarity and transparency. However, whether some sort of tacit approval could make sense in smaller institutions should be analysed.

Question 203.1 No.

Question 203.2

As set out above, we believe such processes should result in the issuance of a decision and that time limits could prove problematic.

Question 204 Yes.

Question 204.1

The DFSA believes that proportionality is key in fit & proper assessments relating to the fit-requirements (proper cannot be proportional). In essence, running a SIFI is more demanding (and carries more risk) than running a small local bank.

Proportionality could relates to e.g. number of years experience from a given area of responsibility, managerial experience etc.

The basis for the proportionality could be the size of the institution in question, the complexity of the institution in question, the inherent risk relating to ML/TF (for AML personel) etc.

Question 205

See above. The second part of the question is not clear. Proportionality exactly entails tailoring requirements to the institution in question.

Question 206

As described above, we believe proportionality is key. One could argue that this could lengthen the time needed to approve board members. However, fit & proper assessments should in any case be individual assessments of the person for the exact role they are being considered for.

Question 207

The DFSA strongly believes such a requirement would be beneficial, a view supported by the experience of the Bank of England and the Management Responsibility Map (MRM). We believe benefits would be several, including a clearer understanding within the organization itself of the division of responsibility, that responsibilities would actually be lifted once they are clearly stated – and as a tool for the supervisor when assessing the board of a given institution. The DFSA is considering to propose the introduction of such a requirement in Danish Financial legislation.

Question 208

We believe such divisions of responsibility already exist – hence terms as CIO, CRO, COO etc. While it should add clarity to some discussions, the risk is that board members might feel lees responsibility for issues not directly within their formal remit. There is also an issue how this relates to company law; and whether this to some extent leads to the collective competencies of the board being included in the assessment of individual directors.

Question 209

The DFSA believes the benefits mentioned above would extend to such a wider "MRM".

<u>Question 210</u> Yes.

Question 210.1

The DFSA is currently working on more specific guidelines for fit & proper assessments of board members depending on their role. The board member responsible for AML should have specific experience with AML issues. Are you the board member with responsibility for credit (or the CEO in a retail bank), you should have worked with credit processes etc.

Question 211-212

While a sound corporate culture is a key component of a well-driven credit institution, it is difficult to include this in fit & proper assessments – even though "sound values" are one component in a fit & proper assessment,

they are not easily enforced or supervised. Corporate culture could be addressed through other initiatives. In Denmark, recent legislation requires credit institutions to have a policy for a sound corporate culture and to ensure that this is enforced within the organization