22.10.2003

KREDITTILSYNET **NORGES BANK**

RESPONSE TO THE COMMISSION SERVICES THIRD CONSULTATIVE PAPER

Review of capital requirements for banks and investment firms

1. On 1 July 2003, the European Commission released its third consultative document on the review of capital requirements for banks and investment firms. This consultative statement was prepared jointly by Kredittilsynet and Norges Bank[1]. Attached are copies of the statements from FNH (the Norwegian Financial Services Association) and Sparebankforeningen (the Norwegian Savings Banks Association).

GENERAL OBSERVATIONS

2. Kredittilsynet and Norges Bank welcome the third consultative document (CP3) issued by the Commission. We are in favour of a revision being carried out of the current capital adequacy rules and remain supportive of the underlying principles of the proposal. Although significant progress has been made since CP1 and CP2, we would like to draw attention to some particular issues we believe deserve consideration before the Commission finalises its proposal in early 2004.

Complexity, level playing field and harmonised supervision

3. Overall, the regulatory framework of the Commission's proposal is substantially more complicated and extensive than the current capital requirements. A complex framework containing a series of options for implementation (at national discretion) and the possibility of different interpretations and application by both banks and supervisors could easily conflict with the basic principle of a level playing field. Moreover, a complicated regime may lead to a situation where only a few persons within the institutions and the supervisory authorities are familiar with the rules and the key factors that determine the institution's capital requirement. Kredittilsynet and Norges Bank would therefore invite the Commission to search for simplifications where possible.

4. Title III entails a substantial change in supervisory methods. The proposal implies that the supervisory authorities will be taking a more active role in evaluating and recognising the risk management systems used by banks, as well as assessing the overall risk and the level of capital adequacy. Title III will increase and highlight the need for harmonisation of international supervisory practices in order to ensure a level playing field. Kredittilsynet and Norges Bank would therefore invite the Commission to give more precise guidelines for the implementation and application of Title III.

Level of capital

5. Kredittilsynet and Norges Bank support the intention to calibrate the new regime so that the minimum capital requirements for banks using the Standardised Approach, taking into account the new operational risk charge, should on average be the same as under the

[1] Kredittilsynet and Norges Bank also provided comments to the first and second consultative documents in 1999 and 2001.

current regulation. Furthermore, we support the intention that, as regards capital requirements, moderate incentives should be provided for institutions to apply more advanced approaches. The Commission states that the results from the QIS3 exercise indicate that the proposed new framework is on target to achieve the calibration objectives. Kredittilsynet and Norges Bank would, however, point out that the QIS3 results show a considerable impact in Title II on the regulatory retail portfolio, including mortgages and small- and medium-sized enterprises (SME) in the Internal Ratings-Based Approach (IRB). This entails a significantly lower capital requirement for the so-called group 2 banks, including the four Norwegian banks participating in the QIS3[2].

6. Prices for residential real estate have in many countries risen considerably in the last decade. It is therefore possible that banks using the internal ratings-based approaches have underestimated the risk on residential real estate in QIS3, and, should prices become more volatile, a larger portion of capital for such loans may be required. The proposal of the Commission to reduce the risk weight from 40% to 35% in the standardised approach is a direct consequence of the low capital requirements that follow from the IRB approach. Kredittilsynet and Norges Bank are also of the opinion that the impact of the reduced capital requirement for SMEs is an area that should be monitored closely over the first years of implementation.

7. In co-operation with FNH and Sparebankforeningen, Kredittilsynet and Norges Bank have conducted a survey of the impact of the Standardised Approach to credit risk and the Basic Indicator Approach to operational risk on a selected group of 21 Norwegian banks (15 savings banks and 6 commercial banks). These banks are small- and medium-sized and did not participate in the QIS3 exercise. The results show an overall reduction in the capital requirement of 10% for the savings banks and 1% for the commercial banks. The outcome of the survey has been set out in paragraphs 86-107. The relatively strong impact on the savings banks is, as in the QIS3 results, mainly driven by lower risk weight for residential property, although retail (including small businesses) also contributes to a significant reduction in the capital requirement.

8. The Norwegian survey and the QIS3 exercise cover 84% of total assets in the Norwegian banking system. Combining the results from both exercises, the weighted average reduction in capital requirement for credit risk is 32%. Operational risk contributes to a 7% increase, which gives an overall reduction in the capital requirement of 25% for the participating banks[3]. Such a significant reduction in capital requirement may thus have a major impact on the aggregate level of capital in the Norwegian banking system.

9. We would furthermore like to point out that the QIS3 exercise is calculated on the basis of banks' current portfolio compositions. As banks adapt to the new rules, we may witness an increase in their exposures in areas where capital requirements are reduced. If banks gradually change their portfolio composition to the new rules, the aggregate level of own funds may be reduced by more than one might expect from the QIS3 results. If portfolio adjustments are fully matched by a reduction in risk exposures, this would be consistent

[2] Two of the banks were not reported to the Basel Committee as they are subsidiaries of foreign banks.

[3] The figures from the QIS3 exercise are based on Foundation IRB. There are several potential IRB banks among the banks that participated in the Norwegian survey. It is therefore possible that the overall reduction in capital requirements will be greater than 25%. The Norwegian survey is, as explained in paragraph 7, calculated according to the Standardised Approach.

with the aims of the new system. However, the fact that the impact might indeed be substantial suggests that one should consider moving forward cautiously. The Commission should take this aspect into consideration before finalising the proposal.

10. Kredittilsynet and Norges Bank note that the structure of the floor capital requirement has been revised so that a single overall floor will apply for the first two years following implementation[4]. In order to ensure transparency as laid down in Title IV and consistency with the standardised approach, we hold the opinion that IRB banks should also publish their capital ratio based on the standardised approach after the first two years of implementation. To ensure satisfactory monitoring of the banking and financial system in its entirety, calculations should be made according to the standardised approach at least twice a year for a transitional period. For monitoring purposes, annual calculations for a longer period should also be considered.

11. Lastly, Kredittilsynet and Norges Bank emphasise the importance of Title III to ensure that banks are adequately capitalised according to their overall risk profile and that each bank has a sufficient buffer of capital to meet unforeseen losses in recessions. *Title III may in this respect also take into account risks that are specific to certain sectors and businesses.* Improved risk management in each bank and more comprehensive supervision will further be crucial to identifying and managing risk.

Definition and composition of capital

12. The new framework increases the need for a review of the capital structure. In our view, the present framework entails an overly complex capital structure in institutions. A hierarchy of instruments in an institution's capital base could impede a speedy solution to an acute solvency problem. The main focus should be on Tier 1 capital, which is the real buffer during a crisis situation. The discussion on whether capital requirements should cover both expected and unexpected losses also highlights the need for a revision of the definition and composition of capital, cf. paragraph 30.

Accounting rules

13. Under the capital adequacy rules, statutory minimum requirements are calculated on the basis of accounting principles. Adequate, harmonised accounting principles are consequently a precondition for a consistent calculation of capital. Harmonised accounting rules are also important in securing a level playing field across national borders. Different valuation rules may substantially affect the size of equity capital, which could in turn lead to competitive distortions.

14. According to EU regulation 1606/2002, international accounting standards must be applied as from 1 January 2005 for listed companies' consolidated accounts. The regulation provides the option to extend the accounting standards to unlisted companies and annual accounts. Accounting rules for listed and unlisted institutions may therefore vary from country to country. Kredittilsynet and Norges Bank support the Commission in recognizing the importance of the need for achievement of maximum consistency between the proposed new prudential framework and international accounting standards (IAS/IFRS).

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[4] Beginning year-end 2006 and during the first year following implementation, IRB capital requirements for credit risk together with operational risk and market risk capital charges must not fall below 90% of the current minimum required for credit and market risks, and, in the second year, the minimum will be 80% of this level.

SPECIFIC REMARKS

Scope of Consolidation

Group, sub-group and individual capital requirements

15. The proposed rules do not include mandatory sub-consolidation requirements for groups located in only one Member State. As stated in our earlier responses, we are positive to a demand for compliance at each level and believe that the application of capital requirements both on an individual basis, on a sub-consolidated basis and on a fully consolidated basis will help ensure that the capital is being allocated in proportion to the degree of risk in various parts of the group. One reason for the requirement of compliance on a sub-consolidated basis is that sub-consolidation permits an assessment of the overall capital available to the sub-group and makes it possible to eliminate double gearing and capital leveraging within the sub-group. On the other hand, in cases where there is no requirement concerning compliance with capital adequacy requirements at sub-group level, the overall risk exposure of the sub-group could be substantially higher than the risk regarded as prudent on the basis of the sub-group's consolidated own funds.

16. The Commission Services raise the issue of potential exemption from the requirement that the rules on capital adequacy be applied at all levels in the group in a limited number of well-defined cases. Our starting point is that a prerequisite for exceptions must be that capital should be available to cover risk and losses wherever they arise. To ensure availability of capital in situations where capital requirements are waived at sub-consolidated and/or solo-levels, a number of conditions must be fulfilled at the same time, for example:

- consolidated funds are sufficient at the level to which the requirements apply,
- there are no legal impediments to the transfer of surplus capital,
- there is an unconditional, explicit and irrevocable obligation for other group companies to transfer surplus capital.

Kredittilsynet and Norges Bank nevertheless consider that the best way to fulfil the principle of availability is that the capital requirements are met at all levels of the group.

17. Allowing too much freedom of choice in the rules may also affect competitive conditions, since institutions in countries that implement the optional sub-consolidation requirements and do not implement the waiver provisions will face stricter regulation.

18. In a few cases, the application of both consolidated/sub-consolidated and individual requirements might be regarded as unnecessary. For example if it is apparent that the capital adequacy calculated on a consolidated/sub-consolidated basis will be substantially lower than the capital adequacy of the parent company. This would particularly apply to a holding company, i.e. a company which is only the parent company in a financial group or part thereof and whose activity is confined to managing its holdings in the group.

Investment firms groups

19. The Commission Services propose new rules restricting the possibility for exemptions from consolidated capital requirements for groups of investment firms. In general we do not support a special treatment of investment firms groups, as investment firms and banks to some extent compete within the same market.

20. As regards the further details of the proposed new rules, one assumes that the risk incidental to investment firms' activities will be reduced due to the restriction on the activities the investment firms may engage in. Through the execution of orders on behalf of investors, cf. the investment services listed in the Annex to Directive 93/22/EEC, Section A, 1b, the activities of investment firms will nevertheless be exposed to settlement and counterparty risk in addition to operational risk.

Title II versus Title III

21. There are no specific rules regarding the scope of consolidation of Title II versus Title III. In the opinion of Kredittilsynet and Norges Bank, it would be sensible to clarify the rules pertaining to the scope of consolidation in relation to Title III - the supervisory review process.

The Standardised Approach

22. Kredittilsynet and Norges Bank remain supportive of the main principles of the standardised approach. The standardised approach will be an important alternative as many smaller and medium-sized banks will neither have the need for, nor be in a position to avail themselves of the internal ratings-based approaches.

Risk-weighting of regulatory retail exposures and claims secured by residential property

23. An important development since the CP2 is the specific treatment of retail exposures where the risk weight has been lowered from 100% to 75% (Article 27 and Annex C-1). Further, the risk weight for residential property has been reduced from 50% to 35% (Annex C-1).

24. As mentioned under General Remarks, a survey of the impact of the standardised approach has been conducted on a selected group of 21 Norwegian banks. The results show an average reduction in the capital requirement for credit risk of 17% for the savings banks and 8% for the commercial banks. Including the capital requirement for operational risk, the average reductions are 10% and 1% respectively. Based on the results from QIS3 and the Norwegian survey, Kredittilsynet and Norges Bank would therefore invite the Commission to reconsider the proposed risk weight for claims secured by residential property and retail exposures[5]. Kredittilsynet and Norges Bank are, however, of the view that increased capital requirements for residential property and retail cannot be considered in isolation for the standardised approach, but must be seen in conjunction with similar capital requirements in the internal ratings-based approach.

Risk-weighting of banks

25. Although alternative 1 (central government risk weight based methodology, Annex C-1) is not in accordance with the principles of risk based weightings, there are considerable disadvantages to small countries with small institutions under alternative 2 (Credit assessment based methodology). These banks will in spite of high capital levels normally not be able to obtain a satisfactory international rating and thus be assigned a risk weight

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[5] Regarding residential property, a possible solution would be to increase the risk weight from 35% to 40%. Another possibility is to introduce explicit loan-to-value ratios (LTV) in the directive. Several countries operate with a favourable risk weight (50%) for residential property within a LTV-ratio of 80% under the current regulation. It is therefore possible to retain the 35% risk weight, but to introduce an LTV-ratio of 60% in the directive. Loans outside the LTV-ratio of 60% could be risk weighted 75% as other retail exposures.

of 50%. Kredittilsynet and Norges Bank therefore support alternative 1, which will entail that banks are assigned risk weights according to the country's risk class. We are further of the view that having two options for risk weighting of institutions might be an important level playing field issue that could influence the funding costs of institutions. Accordingly, we would urge the Commission to consider whether only one of the options, alternative 1, should prevail in the EEA area.

External credit assessment institutions (ECAI)

26. According to paragraph 61 in *The New Basel Accord* (third consultative document), the assessment of an ECAI should be based on methodologies combining both qualitative and quantitative approaches. The Commission's proposal does not contain a similar provision[6]. Kredittilsynet and Norges Bank would like to stress the importance that the assessment should combine both qualitative and quantitative approaches. Assessments that only depend on quantitative measures (such as accounting figures) will not capture all the risk characteristics of an entity. It is of decisive importance that the assessment also includes judgement of the quality of management, strategy etc.

27. Kredittilsynet and Norges Bank support the principles regarding recognition of ECAIs and the mapping of risk weight to different credit ratings (Article 30-40 and Annex C2). We are, however, of the opinion that the wording of the provision is general and that more detailed rules could enhance convergence and consistency.

28. Kredittilsynet and Norges Bank support the waiver (Article 39-40) that allows for optional recognition of ECAIs and mapping decisions by the competent authorities in different Member States. It might be an unnecessary burden for both rating agencies and supervisory authorities if recognition is required by each Member State.

The Internal Ratings-Based Approach

29. Kredittilsynet and Norges Bank remain supportive of the internal ratings-based approaches (IRB) and the incentives towards risk-based models that are embedded in the proposal. The proposal will contribute to increasing the quality of risk management and to more wide-spread use of risk-based pricing.

Expected and unexpected losses

30. Kredittilsynet and Norges Bank note that the Basel Committee in its press release of 11 October communicates a proposal to separate the treatment of unexpected and expected losses within the IRB approach. Kredittilsynet and Norges Bank will consider the proposed treatment and provide comments to the Basel Committee within 31 December 2003. We would expect the Commission Services to reconsider the IRB-approach following the proposed amendments.

Pro-cyclicality and stress tests

31. Kredittilsynet and Norges Bank welcome the efforts to reduce the pro-cyclical effects of the IRB approach. In addition to flattening the risk weight curves compared to the second consultative paper, the Commission Services propose stress testing as a means to develop capital buffers above the minimum requirement.

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[6] Annex C-2 does however state that "*competent authorities must be able to receive from the ECAI the extent of its contacts with senior management of the entities which it rates*".

32. The pro-cyclical effects of the proposed regulation also depend on the time horizon applied by institutions in their rating process. Kredittilsynet and Norges Bank support the reference that although the time horizon used to estimate the probability of default is one year, institutions must use a longer time horizon in assigning ratings (Annex D-5, paragraphs 15-17).

Asset classes

33. Kredittilsynet and Norges Bank would like to see clearer distinctions between the Corporate and Specialised Lending (SL) asset classes. For example, it is not clear whether the Income Producing Real Estate (IPRE) definition excludes a real estate company with more than one property (Annex D-1, paragraph 14 uses the term "the asset" in singular form), and if not, how well diversified it should be in order to be considered non-SL corporate. In addition, there is also considerable room for discretion on the interpretation of the wording "depend primarily".

34. Kredittilsynet and Norges Bank further question the ruling that qualifying revolving retail exposures shall be uncommitted (Annex D-1, paragraph 9). This criterion is in certain countries incompatible with consumer protection standards and legislation. We further believe that the wording "uncommitted" is ambiguous, and that there is a need for an exact definition.

Partial use

35. Kredittilsynet and Norges Bank support the option for IRB institutions to apply the Standardised Approach permanently for exposures to institutions and sovereigns when the number of counterparties is limited and subject to supervisory approval (Article 50). Further, we would like to see Article 50 making it clear that the combined use of methodologies is primarily intended for use by smaller and medium-sized institutions, for which there are likely to be few institutions and sovereigns as counterparties. For larger institutions, supervisors should not be expected to grant approval for the combined use of methodologies. These institutions should be expected to implement the IRB Approach for all asset classes.

Transition arrangements

36. In general, we find it important that institutions' IRB systems are relatively well developed and integrated into their businesses at the time the institutions apply for recognition from the supervisory authorities. It is therefore important to avoid a situation where the legitimacy of the new capital requirements is undermined as a result of pressure for increasingly more liberal implementation and where the transitional provisions become permanent.

37. More specifically, we are very concerned about the relaxation of the PD time series from five to two years (Article 146). We believe that five years as the PD time series requirement is already short. Further, we are concerned about the relaxation of the requirement that institutions' rating systems must have been broadly in line with minimum requirements for the three years prior to qualification. However, the LGD floor for retail is in our opinion justified and this floor – or an LGD floor as such – could well be upheld as part of the general rules.

Maturity

38. The proposed regulation specifies effective maturities to be required only in the Advanced IRB Approach (Annex D-3, paragraph 9). In the Foundation IRB Approach, the rules specify either 2.5 years maturity or effective maturities subject to national discretion. Maturity has a definite impact on risk and Kredittilsynet and Norges Bank are of the opinion that this risk should be reflected in the capital requirement. Further, if the effective maturity requirement is communicated at an early stage, this should not be a major burden for institutions when preparing for the implementation of the new rules. Against this background, Kredittilsynet and Norges Bank propose that the national discretion option be removed and that compulsory effective maturity requirements in the Foundation IRB Approach should be introduced. Correspondingly, and with view to the fact that relatively few companies have consolidated sales and assets of €500 million or above, we believe that the paragraph 11 of Annex D-3, which specifies the size exemption to effective maturity, should be deleted. This proposal should be seen as part of an effort to make the regulation less complex.

Equity exposures

39. The Working Document specifies risk weights of 100-150 % under the Standardised Approach and 300-400 % under the IRB Approaches' Simple Risk Weight Approach (Annex C-1, paragraphs 11, 12.1.5, and Annex D-2, paragraph 1.3.1). Kredittilsynet and Norges Bank believe that these risk weights applicable to equity holdings under the Simple Risk Weight Approach and the Standardised Approach should be aligned. We believe that there is no justification for this vast difference in risk weights.

Validation

40. Kredittilsynet and Norges Bank welcome the progress that has been made on the provisions regarding validation (Annex D-5, paragraphs 94-99). We support the requirement that Foundation IRB institutions shall compare realised LGDs and EADs to the supervisory LGDs and EADs. The requirement that institutions shall revise estimates upward when realised values continue to be higher than expected could be clarified.

41. We would also like to point out the need for sufficient time series in order to perform validation through the economic cycle, c.f. our comments concerning the time series of the Transition arrangements in par. 37.

Treatment of SME

42. The incorporation of small- and medium-sized enterprises (SMEs) as a distinct entity is an important part of the new capital framework. The Commission Services propose a more favourable treatment of exposures to small- and medium-sized enterprises in both the standardised and internal ratings based approaches. We would like to stress that the role of prudential capital requirements is to ensure the safety of banks and financial stability. When setting regulatory capital requirements, it is important that any favourable treatment can be justified in terms of risk.

43. The firm-size adjustment for small- and medium-sized enterprises applies to corporate exposures where reported sales of the consolidated group of which the firm is a part are less than €50 million (Annex D-2, paragraph 1). Kredittilsynet and Norges Bank welcome the Commissions proposal that "*Institutions shall substitute total assets of the consolidated group for total sales when total sales are not a meaningful indicator of firm*

size and total assets are a more meaningful indicator than total sales." An alternative stricter solution would be to require that neither total sales nor total assets shall exceed €50 million. A stricter solution should be considered as such counterparts may be seen as significant for many smaller European banks.

44. As to "retail equity" treatment, in the explanatory document paragraph 175, we support the Commission's view that a different and favourable treatment is not warranted.

45. Regarding retail exposures in the standardised approach, Kredittilsynet and Norges Bank are of the opinion that the definition of "small business" (Article 27) should be made more explicit. Our experience from the impact studies indicates a substantial element of subjective judgement both by banks and supervisors, which is an important level playing field issue. It should also be taken into consideration that a less explicit definition could enforce a practice where a larger portion than intended of corporate exposures is classified as "small business".

Covered bonds

46. Kredittilsynet and Norges Bank welcome a European standard on the treatment of covered bonds in the capital adequacy context. We also support the increased risk sensitivity in the proposal compared to the current regulation.

Credit risk mitigation

47. Kredittilsynet and Norges Bank are in favour of greater acceptance of the use of risk mitigation techniques in calculating the total amount of risk weighted assets. We also believe it is important to establish incentives, such as regulatory capital relief, to enhance risk sensitivity by using these techniques where the transfer of risk is real and irrevocable. The Working Document has obtained such incentives by proposing a number of credit risk mitigation techniques, ranging from simple to sophisticated.

Financial collateral

48. To calculate the effect of financial collateral, four different methods have been introduced. Kredittilsynet and Norges Bank see the logic of having a comprehensive approach that provides incentives for advanced risk measurement as well as a simpler method for less sophisticated institutions. However, having too many approaches can make the regulation complex and difficult to manage. The comprehensive method allowing the banks to use their own estimates of volatility adjustments will require the supervisory authorities to assess whether the criteria in Annex E-3 paragraph 3.1.3.2 (ii) have been met. Kredittilsynet and Norges Bank would invite the Commission Services to consider whether it might be possible to simplify the proposal.

49. One of the conditions for recognising financial collateral, i.e. that the market value of such collateral must be revalued *with a minimum frequency of once every six months*, might be too lenient (Annex E-2 paragraph 2.1.3.1(c)). Kredittilsynet and Norges Bank believe the requirement to revalue the collateral should be *with a minimum frequency of once every three months.*

50. In Kredittilsynet's and Norges Bank's view, the simple approach should be available for the trading book as well as the banking book for banks using the standardised approach

for credit risk (Annex G-5 paragraph 2(a)). It will be an unnecessary burden to require the comprehensive approach for banks with relatively small and insignificant trading portfolios.

Physical collateral

51. Kredittilsynet and Norges Bank support the Commissions conclusions regarding recognition of non-financial collateral as set out in Explanatory Document paragraphs 200-214. Accordingly, we are not supportive of an extension of the proposed eligible physical collateral, neither in the Standardised approach nor in the IRB-approach. It should be stressed that physical collateral should be subject to real and prudent valuation and that realisation of the value within a reasonable period of time is possible.

Unrated and unlisted bonds issued by banks or investment firms

52. The Commission is proposing to recognise bonds issued by unrated and unlisted banks and investment firms as eligible collateral. In order to solve the liquidity issue, the Commission is proposing to require a "repurchase clause" for the issuing institution. Kredittilsynet and Norges Bank are concerned that the repurchase clause will induce unpredictable duration of banks and investment firms funding, thereby increasing liquidity risk. Further, a repurchase clause must be met by an explicit capital requirement which also may influence the funding through higher funding costs.

Minimum requirements for guarantees

53. When interests are paid in arrears, a guarantee covering only the principal will provide less risk cover than a guarantee covering both interests and principal (depending on the frequency of interest payments). It is in the opinion of Kredittilsynet and Norges Bank that if principal-only guarantees are to be recognised, there must be a method to adjust for the reduced cover, e.g. by calculating a capital charge for future interest payments not covered by the guarantee.

54. Kredittilsynet and Norges Bank support the Commission's proposal to accept sovereign counter-guarantees as eligible guarantees. A condition for this should be that there is no doubt that the counter-guarantee is as good as a direct sovereign guarantee in covering losses. This means that the counter-guarantee must cover credit risk on the original guarantor as well as the debtor of the claim. In the event that the guarantee is triggered and the original guarantor fails to make payments due, the counter-guarantor must be obliged to pay in a timely manner. This may be accentuated by saying in Annex E-2 item 2.2.1.3:

    i): that the counter-guarantee covers all credit risk elements of the claim, <u>*including credit risk on the original guarantor.*</u>

55. It is in the opinion of Kredittilsynet and Norges Bank that guarantees covering losses after collateral has been realized is less efficient as a risk cover compared to an ordinary guarantee.

56. The requirement for a guarantee to be entirely conditional has been replaced by a list of clauses that will not be accepted, cf. Annex E-2 item 2.2.1.1. c). In order to reduce the risk that the institutions will evade the regulation, Kredittilsynet and Norges Bank propose to include an omnibus item in this list covering clauses that:

(v) in other ways (other than those mentioned in i) to iv)) will affect the efficacy of the guarantee as a method of protection.

Real estate lending

57. Kredittilsynet and Norges Bank note the Commission's significant achievement in developing an appropriate framework for real estate lending/loans secured by real estate. We have only a few comments on the proposal.

58. As in many other countries, commercial property lending was one of the main factors causing troubled assets and problems in the Norwegian banking sector at the beginning of the 1990s. It is in the opinion of Kredittilsynet and Norges Bank that an option in the Directive permitting a favourable treatment of such loans should be subject to strict conditions. However, the proposal to use an annual "hard test" may have undesirable effects, i.e. the capital requirement for such loans will rise after losses have occurred.

59. Annex E-1 paragraph 2.1.4 sets out the minimum requirements for the recognition of real estate collateral under the IRB Foundation Approach. It is the opinion of Kredittilsynet and Norges Bank that these requirements should be applied to all methods.

Asset securitisation

60. Kredittilsynet and Norges Bank welcome a European standard on the treatment of securitisation in the capital adequacy context.

61. A new Act regulating securitisation of loans was adopted by the Norwegian parliament (the Storting) early in November 2002 (not yet in force). A major concern in the preparation of this Act was the requirement to have a clean break, both formally and in practice, between the operating financial institution and the special purpose entity that securitises the loans. The draft directive defines clear terms and conditions for ensuring a clean break between the portfolio sold and the lender bank. This is a very important precondition if the bank no longer has to calculate capital requirement for the portfolio sold. The proposal in its present form will be a positive contribution towards a harmonisation of the regulatory framework for securitisation in the various countries. One could, however, at the same time ask whether the regime is too complicated, and whether it may lead to a situation where only a few persons within the institutions and the supervisory authorities are familiar with the rules.

Trading book

62. It is in the opinion of Kredittilsynet and Norges Bank that the concept of valuation reserves in Annex G-2 item C is too ambiguous to be kept within Title II and should be moved to Annex I concerning Title III provisions.

63. Kredittilsynet and Norges Bank welcome a more risk-sensitive approach concerning the treatment of CIUs (Collective Investment Undertakings) in the trading book, and we clearly see the need for developing a more risk-sensitive approach for CIUs in the banking book as well.

64. The proposal for Disclosure-requirements in Annex G-3 paragraph 3 b) indirectly requires CIUs to have a limited counterparty exposure arising from OTC financial derivatives or repo-style transactions. Kredittilsynet and Norges Bank are in favour of such a requirement, but think it should be explicitly stated whether this means that the capital requirement for counterparty risk arising from such transactions is disregarded for CIUs.

65. Concerning the treatment of foreign exchange risk related to CIUs, Kredittilsynet and Norges Bank support the proposal in Annex G-3 paragraph 12 based on the "modified gold method". It is in the opinion of Kredittilsynet and Norges Bank that the currency of the CIUs' investments better reflects the actual foreign exchange risk than the denomination of the CIUs. However, as many CIUs use foreign exchange derivatives to hedge the currency risk, the text should be amended to reflect this, for example by stating:

    "*Whenever the investment mandate makes it clear that an investment in the CIU may imply foreign exchange risk as a result of investments different from the investing institution's base currency whether identical to the CIU's denomination or not – the investing institution shall calculate a capital charge for foreign exchange risk for its CIU investments".*

66. Regarding counterparty risk as a result of unsettled transactions, Kredittilsynet and Norges Bank are in favour of repealing the current CAD where the institutions have a 5 day "grace period" after the settlement date before a capital charge is incurred. However, we would like to see some modifications in Article 102. It is in the opinion of Kredittilsynet and Norges Bank that settling transactions within the ordinary settlement period (2-3 days) should be excluded from this treatment. In addition, it is necessary to develop further guidance as regards the amount of exposure to be used as a basis for calculations.

Operational risk

67. Despite the tables given in Annex H-8, Kredittilsynet and Norges Bank still call for clearer definitions and divisions between risks. The line between credit losses and operational losses could be clearer. In particular, this applies to institutions that employ risk sensitive IRB systems for credit risk and non-sensitive Basic Indicator or Standardised Approach for operational risk.

68. On a general note, Kredittilsynet and Norges Bank are concerned with the option of choosing between the different approaches. We point out that institutions whose main activities are Corporate Finance, Trading and Sales, and/or Payment and Settlement have no incentive to move from the Basic Indicator Approach to the Standardised Approach. We are also concerned about the options to combine methodologies (Annex H-5); specifically, we question whether any institution eligible for the Advanced Measurement Approach for part of its operations will need to employ the Basic Indicator Approach, rather than the Standardised Approach, for any of its portfolios. We believe that the qualifying criteria for the Standardised Approach should be within reach for institutions eligible for the Advanced Measurement Approach for part of its operations; in our opinion, the fact that the current proposal only requires the Advanced Measurement Approach to be employed for one material part of the institution (in contrast to the proposed Basel Accord, where the requirement is *all* material parts) only enhances the need for such a restriction.

69. In the current Basel consultative paper, reverting to a simpler methodology is subject to supervisory approval, a rule absent in the proposal of the Commission Services. Kredittilsynet and Norges Bank hold the opinion that an institution should not be permitted to change methodology without the approval of competent authorities.

70. The proposal seems to impose weaker qualifying criteria for the Standardised and Advanced Measurement approaches, compared to the currently proposed Basel Accord. Kredittilsynet and Norges Bank question the need and the desirability of doing so, in particular for the Advanced Measurement Approach.

71. Kredittilsynet and Norges Bank emphasise the need to assess the tail of the loss estimates and to validate the risk measures as put forth in Annex H-4. Considering that five years of internal data will not cover infrequent serious incidents, we strongly support the requirement for external data in conjunction with scenario analyses.

72. Kredittilsynet and Norges Bank are of the opinion that recognition of insurance is, inherently, suited to the Advanced Measurement Approach and not the Standardised or Basic Indicator Approaches. We note that the risk of non-payment will be affected by the regulatory capital regime applicable to the insurer.

Investment firms

73. Kredittilsynet and Norges Bank are positive to the general approach to operational risk considered for investment firms. We further support the view that the business lines used to derive the capital charge should be adapted to take account of the specific situation in the EU. Kredittilsynet and Norges Bank also support the view that further modification of the proposals is necessary in order to provide an appropriate operational risk treatment for investment firms authorised to carry out a limited range of activities.

74. Kredittilsynet and Norges Bank support the proposed modifications on firms authorised to carry out a limited range of activities. However Kredittilsynet and Norges Bank find the category of firms with limited licence to be too wide. Kredittilsynet and Norges Bank considers that investment firms authorised to provide the investment service covered under section A of Annex I to the Investment Services Directive (Directive Proposal COM (2002) 625 final) (2) “Execution of orders on behalf of clients” should be included in the list in Annex H-1.

75. Kredittilsynet and Norges Bank are of the opinion that references to investment services should be consistent. Referring to what should not be considered as limited licences, Annex H1 of the Working Document refers to the Investment Services Directive (Proposal COM (2002) 625 final), whereas article 21 (d) regarding the consolidation of investment firms groups, refers to the services listed in Directive 93/22/EEC (ISD).

76. In Kredittilsynet’s and Norges Bank’s opinion the proposed scope of consolidation for investment firms with limited licence in article 21 does not correspond to the proposal outlined in section 14 paragraph 357 of the Explanatory Document. In particular this applies to article 21 (e).

Supervisory review process

77. Kredittilsynet and Norges Bank support the basic premise behind the Supervisory Review Process. Title III may promote sound practices in the banking industry by means of effective supervision of banks at the same time as the banks are given an incentive to develop and improve their risk management systems.

Risk based capital requirements

78. Kredittilsynet and Norges Bank support the principle in article 126 that the intensity of the evaluation process shall be proportionate to the systemic importance, nature, scale and complexity of the activities of the institutions concerned. We believe that the article provides an appropriate balance to comply with the underlying principles of the risk-based capital requirements.

Transparency with respect to individual capital requirements

79. According to Article 129, "*Requirements to hold an amount of own funds higher than that prescribed in Article 3 shall not be published*." Kredittilsynet and Norges Bank believe that individual capital requirements set by supervisors should be made publicly available. When a bank does not provide information about individual capital requirements, the bank appears to be more solid than other banks that have no such requirements. In our view, this is misleading information to the market and not in accordance with the intentions of Title IV. Kredittilsynet and Norges Bank observe that this issue is addressed in IASB Update May 2003 (International Accounting Standards Board), which indicates that such disclosure may be made mandatory. We also note that listed companies must comply with disclosure requirements of the Market Abuse Directive (article 6). The proposal to prohibit disclosing individual capital requirements might thus be in conflict with the goal of greater transparency and enhancement of market integrity in relation to listed companies, both under the Market Abuse Directive and current legislation for listed companies (as they are required to disclose to the public any information that would be likely to have a significant impact on the price of the company's shares).

Supervisory disclosure

80. In paragraph 65 in Explanatory Document, the Commission are seeking views on whether supervisory disclosure requirements should be included in the directive proposal. Kredittilsynet and Norges Bank support a principle of enhanced requirements concerning supervisory disclosure to promote convergence in the application of the new framework and to ensure a level playing field for European financial services institutions. Further, supervisory disclosure is also important in terms of the accountability of supervisory authorities.

Market discipline

81. Market discipline consequently provides for a set of disclosure requirements aimed at facilitating the exercise of market discipline and addressing notably the bank's capital structure, capital adequacy and risk exposures. Kredittilsynet and Norges Bank welcome the progress since the second consultative paper to streamline the disclosure requirements.

Frequency

82. According to Article 139, entities have to publish the disclosures required on an annual basis at a minimum. In addition, competent authorities shall require the entities to assess

the need to publish some or all disclosures more frequently than annually in the light of the criteria set out in Annex L-1, paragraph 4. Kredittilsynet and Norges Bank support this approach. Given the increased risk sensitivity of the new rules, we are however of the opinion that institutions shall disclose their own funds, capital requirements and solvency ratios on a quarterly basis. Such an approach would be in accordance with the Basel proposal.

Medium and location of the disclosures

83. If information is not provided with the accounting disclosure, institutions should indicate where the additional information can be found (Article 140). Kredittilsynet and Norges Bank recommend that institutions disclose exactly where this information can be found.

Large exposures

84. Kredittilsynet and Norges Bank regard the regulation of large exposures as one of the most important regulatory measures to safeguard the strength of financial institutions. Experience has demonstrated that financial institutions that often experience problems because of losses and defaults related to their largest exposures, even when the exposure is collateralised. Large exposures represent a substantial risk for creditors and regulations must be formulated in such a way that institutions' calculations of the size of exposures are easy to verify and difficult to manipulate. An underestimation of the size of the exposure will not be offset by risk diversification in the rest of the lending portfolio as is the case in the event of miscalculations of the size of the exposure in relation to capital adequacy rules. Kredittilsynet and Norges Bank considers therefore that requiring other calculation methods in the large exposure context compared to capital adequacy calculations is well justified. In the current regulation of large exposures in Norway, only guarantees from particularly solid debtors, collateral in government bonds and cash deposits, have been recognised.

85. Kredittilsynet and Norges Bank believe that financial institutions should not be able to use their own methods in calculating the adjusted exposure amount. As an absolute minimum, advanced IRB banks must be subject to the requirements in Title II, Chapter 1, Section III, Annex E-2. Furthermore, a cautious approach will require a restriction on the types of risk mitigating techniques to be approved. We are sceptical in particular to collateral that falls in value because the debtor is in a crisis situation or where realisation of the collateral requires selling such a large share of the market in a security that the market value is affected. This is a relevant issue in a small market such as the Norwegian market.

CONSEQUENCES FOR THE CAPITAL REQUIREMENT IN NORWEGIAN BANKS

Introduction

86. In co-operation with the Norwegian Financial Services Association and the Norwegian Savings Banks Association, Kredittilsynet and Norges Bank have carried out an impact study based on the Standardised Approach (credit risk) and Basic Indicator Approach (operational risk) on a sample of 15 savings banks and 6 commercial banks. These banks did not participate in QIS3 and are regarded as small- and medium-sized banks.

87. Calculations in the survey were based on consolidated data as of 31 December 2002. A presentation of the assumptions underlying the survey is set out in Annex 1.

88. The results show a decrease in capital requirements relative to the current requirements for all the savings banks. On average the reduction is significant. The impact is not as large for the commercial banks although the average figures show a small reduction in overall capital requirements.

Table 1. Overall percentage change in capital requirements

	Average	Max	Min
Savings Banks	**-10**	-5	-17
Commercial Banks	**-1**	7	-20

Summary of Results

89. The participating savings banks account for 37% of total assets among all the Norwegian savings banks and 17% of total assets in the Norwegian banking system. The corresponding figures for the commercial banks are 11% and 6%.

90. The data quality is generally satisfactory. There is, however, some uncertainty regarding the data for the regulatory retail portfolio. Several banks were not able to identify loans to individuals and small businesses and estimates have therefore been made.

91. The portfolio structure of the savings banks is relatively homogeneous. A simple average has therefore been applied when summarising the results. The portfolio structure of the commercial banks is less homogeneous and a weighted average has therefore been applied.

92. Table 2 illustrates the average portfolio composition. The contributions to change in capital requirements are illustrated in table 3.

Table 2. Portfolio composition[8]

Portfolio	% of exposures	
	Savings Banks	**Commercial Banks**
Corporate	19 %	55 %
Regulatory retail (of which);	15 %	10 %
-Individuals	6 %	5 %
-Small businesses	9 %	5 %
Claims secured by residential property	63 %	34 %
Other portfolios[7]	2 %	2 %
Total	100 %	100 %

Table 3. Contributions to Change in Capital[8]

Exposures	Contribution %	
	Savings Banks	**Commercial Banks**
On balance		
Retail (of which);	-5 %	-3 %
-individuals	-2 %	-2 %
-small businesses	-3 %	-1 %
Claims secured by residential property	-14 %	-7 %
Past due	0 %	2 %
Off balance		
Commitments under 1 year	1 %	2 %
Other off balance	0 %	0 %
Overall credit risk	-17 %	-6 %
Operational risk	7 %	6 %
Overall change	-10 %	-1 %

93. The capital requirements for **credit risk** show a significant reduction for both savings banks and commercial banks compared with the current regulation. The new **operational risk** requirement does not outweigh the reduction in credit risk capital requirements for the savings banks, which results in a significant overall reduction by 10%. The overall change for the commercial banks is a 1% reduction.

94. The main area of activity where the minimum requirements will change substantially is the retail portfolio and claims secured by residential property, where the risk weights have been lowered significantly relative to the current regulation. The large contribution reflects the combination of these changes with the importance of retail and residential mortgage portfolios, especially for the savings banks, see also table 2.

95. Past due loans only have an impact on the commercial banks. Other off balance sheet items (including OTC derivatives) do not have an impact on the average results for savings banks or commercial banks, although these are significant factors for some of the participating banks.

[7] Includes interbank exposures, claims on regional governments etc.
[8] The numbers does not sum up correctly due to rounding.

96. Note that the risk weights for the corporate portfolio and “other portfolios” are assumed unchanged compared with the current regulation and are therefore not included in table 3. See annex 1 for further explanation.

97. The average increase in the overall capital requirement due to operational risk is 7% for the savings banks and 6% for the commercial banks and shows little variation among the participating banks.

Annex 1. Assumptions – Norwegian survey of the impact on capital requirements for Norwegian Banks

98. Annex 1 describes the assumptions underlying the Norwegian survey.

Credit risk

99. The survey does not calculate the effect of all the elements of the standardised approach, but focuses on elements that are known to have a strong impact on the capital requirement. The survey does not calculate the effect of external ratings or credit risk mitigation.

Retail

100. The definition of retail is identical to the definition in Article 27 item 2. Regarding the granularity criterion (third bullet point), the 0.2% threshold is applied as a hard limit. In addition, "small business" was defined as businesses with fewer than 20 employees and managed as retail exposures.

Claims secured by residential property

101. The 35% risk weight is applied to loans within a loan-to-value ratio of 80%. Loans above 80% are assigned a risk weight of 75% according to the regulatory retail portfolio.

Claims on banks

102. The survey assumes a 20% risk weight for interbank exposures. In Norway this implies the same risk weight as under option 1 (central government risk weight methodology in Annex C-1 item 6.3).

Corporate

103. A 100% risk weight is assumed for corporate exposures, as in the current regulation, reflecting the low level of externally rated companies in Norway.

Past due loans

104. To simplify the calculations, a 150% risk weight is applied to past due loans other than claims secured by residential property. The risk weight for claims secured by residential property is 100%.

Commitments

105. A 20% credit conversion factor was applied to commitments with an original maturity up to one year (and a 50% conversion factor for commitments over one year).

Derivatives

106. A 100% risk weight was applied to OTC derivative transactions both in the banking and trading portfolio, which are assigned a risk weight of 50% under the current regulation.

Operational risk

107. Gross income is defined according to Annex H-2 and Norwegian accounting rules.