Nordic Working Group on Basel III/CRD IV and National Discretion

Report from the Nordic working group consisting of representatives from the Nordic ministries responsible for financial markets regulation in the Nordic countries

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1 Executive summary

The Nordic finance ministers agreed in November 2011 to appoint a high-level working group to assess various aspects of the forthcoming CRD IV framework and the impending implementation of this legislation into national law, including possible cooperation between the Nordic countries. A mandate for the working group was specified and approved on 10 January 2012.

At the time of finalisation of the working group's report, the CRD IV framework was subject to trilogue negotiations between the European Commission, the Parliament and the Council. The working group has based its considerations on CRD IV versions adopted by these three legislative bodies.

The CRD IV framework will be a recast of the EU's current capital requirements directives, and it will include the transposition of the so-called Basel III standards into EU law. In brief, the Basel III transposition includes, *inter alia*, a strengthening of minimum capital requirements, new capital buffer requirements and new quantitative liquidity and funding requirements. The new requirements are to be phased in over a period of several years, from 2013 to 2019.

The new capital requirements within the CRD IV do not appear to pose challenges for Nordic credit institutions as a whole. Most institutions already meet the requirements with good margins. Many Nordic credit institutions are in a good position to fulfil the new liquidity and funding requirements as well, even though limited availability of certain liquid assets is a concern in some Nordic countries. The latter issue may be resolved by modifying existing definitions, e.g. in line with options suggested by the Basel Committee. Some authorities are in addition concerned about the increasing reliance on internal risk models for the calculation of capital requirements, as the historical data used in such models may not be suitable proxies for future risk.

The final CRD IV framework will probably include some flexibility at the national level, whereby national authorities may impose stricter prudential requirements, and/or introduce new (and possibly stricter) requirements earlier than the CRD IV timeframe. The CRD IV framework therefore does not appear to prevent the Nordic countries from establishing cooperation on prudential requirements or to otherwise adopt a coordinated approach.

The integration of Nordic financial markets may give grounds for Nordic cooperation and coordination on prudential requirements. Most foreign institutions operating in the Nordic countries are domiciled in other Nordic countries. Foreign institutions domiciled outside the Nordic area have a very small share of the Nordic credit market. Due to the integration, financial stability in the Nordic region may depend on the soundness of financial institutions in the Nordic region as a whole. But the competitive environment on the supply side in the Nordic financial markets may raise barriers for stricter rules in one or some countries, as this may contribute to a market shift towards other Nordic institutions.

Viewed against this background, the working group's principal conclusion is that Nordic coordination on new liquidity, funding and capital requirements – as well as on residential mortgage loan risk weights – is possible and desirable.

The introduction of the new CRD IV *liquidity and funding requirements* lies some years into the future. The liquidity coverage requirement (the LCR) is to be defined by the European

Commission, and introduced as a binding requirement, in 2015 at the earliest. The net stable funding requirement (the NSFR) may be introduced in 2018 at the earliest. In the working group's view, a common Nordic LCR definition – and perhaps also a common NSFR definition – could be useful until harmonised requirements are decided by the EU and entered into force, and should be analysed further. However, Sweden plans to introduce a Swedish version of the LCR from 1 January 2013. Common definitions could have a disciplining effect across the Nordic region, even if the individual Nordic country only were to apply the definitions as supervisory tools and reporting standards. Common definitions could in addition ease comparison and improve transparency between institutions domiciled in different Nordic countries.

A common Nordic LCR definition could in principle be in place from 1 January 2013. If a common LCR definition were to be pursued, the working group envisages that the Nordic supervisory authorities may be asked to analyse the possibility for a joint LCR definition. Following the supervisory authorities' analysis of the possibility and potential for a common definition, the relevant national authority could decide whether to go forward with the definition as a binding requirement, a reporting standard or guidance.

In order to avoid a potential call for a "race to the bottom" with regard to prudential requirements, and to safeguard the stability and competitiveness of each country's financial sector in accordance with national considerations and preferences, the Nordic countries may establish a system of mutual recognition of *capital requirements* for exposures incurred in the country setting the requirement (reciprocity). Such a system could imply that if a Nordic country were to implement stricter capital requirements to, say, prevent and mitigate systemic risk in that country, the other Nordic countries would accept that these requirements were to apply for all relevant exposures incurred in that country by all Nordic institutions operating there. The working group envisages that the Nordic supervisory authorities may be asked to look further into the possibility of establishing a Nordic reciprocity system on capital requirements, including an impact study and a mapping of the specific legislative measures necessary to establish such a system.

Reciprocity in this context may allow individual countries the flexibility to set stricter prudential requirements for domestic exposures in accordance with specific national circumstances, without conflicting with the "level playing fields." Such a system would of course not prevent any country from implementing the baseline CRD IV framework if it so desires, but it would prevent such a country's financial institutions from operating on laxer terms in other countries which choose to have stricter requirements. If a group of countries were to establish such a reciprocity system, efficiency considerations may imply that the system should be as broad as possible, covering the sum of stricter capital requirements as such, leverage ratio requirements, the counter-cyclical buffer, the capital conservation buffer and the systemic risk buffer. The CRD IV framework does not appear to prevent countries from establishing a system of reciprocity or from otherwise adopting a coordinated approach to prudential requirements. Further, the forthcoming CRD IV framework will probably also explicitly include reciprocity to some extent.

How credit institutions calculate their total risk exposure (risk-weighted assets), is of great importance for their actual capital adequacy ratios. Both the current and the forthcoming EU rules on *residential mortgage loan risk weights* leave room for imposing stricter rules at the national level, and several options may be available to national authorities wishing to increase risk weights. The forthcoming CRD IV framework will probably also include reciprocity for

decisions made by host country supervisory authorities on risk-weighting of real estate exposures, meaning that such decisions also will apply for subsidiaries and branches operating in the host country. On a Nordic level, a joint or coordinated approach can be achieved in cross-border supervisory colleges and in meetings between Nordic supervisors, where the supervisors in principle can effectuate measures to increase these risk weights.

Moreover, a joint or coordinated approach may be included in a broad Nordic reciprocity system; cf. above. Here, reciprocity would refer to a mechanism in which the host country's rules on the calculation of residential mortgage exposure risk weights will apply for exposures incurred in the host country setting the requirement, regardless of whether the exposures are incurred by institutions domiciled there, by subsidiaries of foreign institutions domiciled within the reciprocity area, or by branches of foreign institutions domiciled within the reciprocity area. In the working group's view, a joint or coordinated approach to rules on residential mortgage exposure risk weights could contribute to "level playing fields" across countries, as well as to easier comparison of capital adequacy ratios between institutions domiciled in different countries.

The working group notes that the Nordic countries already cooperate on financial regulation and supervision. We also note that the role and powers of the financial supervisory authorities differ somewhat between the Nordic countries. Some authorities are for instance more independent of the responsible ministry than others. This will delimit the potential for cooperation and coordination at the ministerial level, and in certain areas necessitate closer cooperation and coordination between supervisory authorities. Moreover, this is also true for the fact that the Nordic supervisory authorities have different ways of practising Pillar II measures under the existing capital adequacy framework.

The working group has prepared this report in parallel to the CRD IV discussions in the Council and the Parliament, and has naturally not been able to build its considerations on a finalised EU framework. Although the working group has reached consensus on several important issues, it may be desirable for the group to meet again later in 2012, after the EU has adopted the directive and the regulation constituting the CRD IV package, to discuss further cooperation between the Nordic countries.

2 Introduction and terms of reference

The Basel Committee adopted new guidelines on capital and liquidity requirements for banks on 16 December 2010, the so-called Basel III standards. On 20 July 2011, the European Commission put forward the CRD IV proposal, transposing the Basel III standards into EU law for credit institutions and investment firms. The European Parliament ECON-committee adopted its CRD IV text on 14 May 2012, while the Council agreed on its text (the general approach) on 15 May 2012. At the time of finalisation of this report, the three versions of the CRD IV package were subject to trilogue negotiations between the Commission, the Parliament and the Council.

At the 1 November 2011 meeting of the Nordic finance ministers in Copenhagen, agreement was reached on appointing a high-level Nordic working group. The working group was tasked with preparing an internal document assessing various aspects of Basel III/CRD IV and the impending implementation of this legislation into national law, including possible cooperation between the Nordic countries on the implementation of the new national legislation. The conclusion from the 1 November 2011 meeting reads as follows [translated from the original Swedish-language text]:[1]

> *"MR-Finans decided to appoint a high-level Nordic working group tasked with preparing an internal document assessing the challenges facing each of the Nordic countries with respect to CRD IV (Basel III)."*

A mandate for the working group was specified and approved by the five Nordic countries on 10 January 2012. It reads as follows [translated from the original Norwegian-language text]:[2]

> *"Capital requirements related to banks' lending shall reflect risk. The current Basel II rules has proved to allow for major differences in the calculation of capital requirements, for instance for mortgages, depending on whether a bank uses the so-called standard method, or internal risk models. It has also become evident that there are differences among banks using internal risk models, both within and outside the Nordic region, and among banks in each country. It is generally large banks that use internal risk models. By using internal risk models, the calculation basis, the denominator in the capital ratio, may be reduced considerably. From a financial stability point of view, there are good reasons for reducing the variation in the calculation capital requirements arising from the use of internal risk models, cf. that all banks should hold more capital behind mortgage loans.*
>
> *The working group shall consider various aspects of Basel III/CRD IV and the impending implementation of this legislation into national law, including possible cooperation between the Nordic countries on the implementation of the new national legislation. In its final report, the working group shall consider inter alia the following:*
>
> - *Joint implementation of the CRD IV (Basel III) with respect to more stringent capital requirements, including countercyclical capital buffer, and liquidity requirements.*

[1] Working group's translation.
[2] Working group's translation.

- *Higher risk weights for banks using internal risk models for calculation of capital requirements on mortgage loans, including coordination of these weights on a Nordic basis. Coordination includes questions regarding host country regulation and coordination of the risk weights between the countries.*
- *Other related issues.*
- *Possible cooperation between the Nordic countries on the new rules."*

The 10 January 2012 mandate also stated that the working group should consist of one/two high-level representative(s) from each of the Nordic countries. The composition of the working group is as follows:

- Mirella E. Wassiluk (chair), Deputy Director General, Norwegian Ministry of Finance
- Tómas Brynjólfsson, Deputy Director, Icelandic Ministry of Economic Affairs
- Fredrik Bystedt, Director General, Swedish Ministry of Finance
- Juho Kivi-Koskinen, Senior Legal Officer, Finnish Ministry of Finance
- Louise Mogensen, Head of Division, Danish Ministry of Business and Growth

In addition, Øystein Løining and Erling G. Rikheim (Norwegian Ministry of Finance), Erkki Sarsa (Finnish Ministry of Finance), Tina Skotte Sørensen (Finanstilsynet, Danish FSA) and Arvid Wallgren (Swedish Ministry of Finance) attended one or several of the working group's meetings. Jens Christian Werring-Westly and Marius B. Østli, both from the Norwegian Ministry of Finance constituted the secretariat, assisted by experts from the Norges Bank and Finanstilsynet (the Norwegian financial supervisory authority).

As mentioned above, the three versions of the CRD IV package were subject to trilogue negotiations between the Commission, the Parliament and the Council, at the time of finalisation of this report. The working group has based its considerations on these three texts, that is:

- The European Commission's CRD IV proposal of 20 July; cf. COM(2011) 452 and COM(2011) 453
- The European Parliament ECON Committee's CRD IV text (report) of 14 May 2012
- The Council's CRD IV text (general approach) of 15 May 2012

These three CRD IV package versions are henceforth referred to as the Commission's proposal, the Parliament ECON Committee's text and the Council's text, respectively.

3 The CRD IV framework and Nordic implementation plans

3.1 Background and key elements of the CRD IV framework

3.1.1 The Basel III standards

The Basel Committee on Banking Supervision adopted new standards for capital and liquidity requirements for banks on 16 December 2010. As these are the third configuration of the standards, they are called the Basel III standards. While the Basel I standards of 1988 aimed to build a general minimum base of own funds in every bank, the Basel II standards of 2004 prescribed more capital for higher risk. The objective of Basel III, which builds on Basel II, is to improve the banking sector's ability to absorb shocks arising from financial and economic stress, thus reducing the risk of spillover from the financial sector to the real economy.

A key component of the Basel III standards is a strengthening of minimum capital requirements. While the minimum total capital an institution will need to hold remains at 8 per cent of risk weighted assets (as in the Basel II standards), the minimum common equity tier 1 (CET1) to risk weighted assets ratio increases from 2 to 4.5 per cent. The minimum tier 1 ratio, which may include hybrid capital instruments as well as CET1, increases from 4 to 6 per cent. In addition, the criteria for qualification of CET1 and tier 1 instruments becomes more stringent, in order to further improve the quality of institutions' capital. The Basel Committee recommends introducing these new capital minima gradually over three years, reaching full effect on 1 January 2015.

The Basel III standards include two new capital buffer requirements; the capital conservation buffer and the counter-cyclical buffer, both of which have to be met with capital of the highest quality. The buffers are also to be introduced gradually, reaching full effect on 1 January 2019. On top of the new Pillar I capital requirements, the Basel Committee recommends that national supervisors retain their current powers to impose additional capital requirements to cover other risks under the Pillar II process.[3] The Basel III standards also include a leverage ratio requirement, which is defined as tier 1 capital divided by a measure of non-risk weighted assets, intended to provide an extra layer of protection against model risk and measurement error.

Table 3.1. Phase-in arrangements according to the Basel III standards

Measure \ 1 Jan. of…	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Min. CET1 ratio	2.0%	2.0%	3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Min. tier 1 ratio	4.0%	4.0%	4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Min. total capital ratio	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Min. conserv. buffer						0.625%	1.25%	1.875%	2.5%
Max. counter-c. buffer†						0.625%	1.25%	1.875%	2.5%
Leverage ratio	Monitoring							Req.*	
LCR	Observation				Req.*				
NSFR	Observation							Req.*	

*Introduction of binding requirement. †The maxima are only relevant for cross-border reciprocity (mutual recognition).

[3] The Basel capital framework consists of three pillars. Pillar I contains requirements that apply across the board and that are binding in nature. Pillar II consists of additional measures that a supervisor might want to impose following a supervisory review process of an individual institution. Pillar III concerns requirements related to disclosure and market discipline.

On liquidity, the Basel III standards include a new quantitative requirement called the liquidity coverage ratio (LCR). The requirement is intended to improve short-term resilience of the liquidity risk profile of financial institutions, and is to be introduced in 2015, after an observation and review period. In addition, the Basel Committee recommends introducing the net stable funding ratio (NSFR) requirement in 2018, after an observation period.

Table 3.1 summarises the new Basel III standards and their planned phase-in arrangements.

3.1.2 The European Commission's proposal

The Basel II standards, with later revisions, are implemented in the Capital Requirements Directives (directives 2006/48/EC and 2006/49/EC), abbreviated CRD. On 20 July 2011, the European Commission proposed a third revision of the CRD, called CRD IV, transposing the Basel III standards into EU law. The proposal divides the current CRD into two legislative acts:

- A new directive governing the access to deposit-taking activities (CRD IV)
- A regulation establishing prudential requirements for the institutions (CRR)

The Commission's proposal includes a strengthening of minimum capital requirements, the introduction of new buffer requirements and the LCR requirement in line with the Basel III standards. The Commission also proposes to start the process of introducing a leverage ratio, initially as a Pillar II measure, before deciding on whether to introduce it as a binding measure from 2018. The proposal does not include the NSFR requirement, but the Commission plans to prepare a NSFR legislative proposal sometime before the end of the observation period (i.e. before 2018).

3.1.3 Council and Parliament ECON Committee texts

The European Parliament ECON committee adopted its CRD IV report on 14 May 2012, while the Council agreed on its general approach to the CRD IV on 15 May 2012. Both texts maintain the main elements of the Commission's proposal, e.g. the new capital minima, with a few changes and additions.

Among the changes introduced by *the Council's general approach* is more flexibility at the national level to implement measures to address systemic risk. The Council's text provides the opportunity for Member States to impose stricter prudential requirements for domestically authorised institutions, i.e. requirements on level of own funds, requirements for large exposures, public disclosure requirements, the level of the capital conservation buffer, liquidity requirements and risk weights for targeting asset bubbles in residential and commercial property. Such a decision by a national authority could according to the Council's text only be overruled if, following a negative opinion by the EBA, the European Systemic Risk Board (ESRB) or the Commission, the Council votes by qualified majority against the measures. Member States would be able to increase risk weights for residential and commercial property and intra financial sector exposures beyond those provided in the CRD IV regulation. Member States would also be able to impose a systemic risk buffer requirement, not dissimilar to the conservation buffer and counter-cyclical buffer requirements.

Among the changes introduced by *the Parliament ECON Committee's text* is the inclusion of a requirement for systemically important institutions meet a systemic buffer requirement,

which to some extent resembles the Council's systemic risk buffer requirement. The Committee's text also includes new provisions on, *inter alia*, governance, remuneration and reduced risk-weighting of loans to small and medium-sized enterprises.

As mentioned introductorily, the three versions of the CRD IV is at the time of finalisation of this report subject to trilogue negotiations between the Commission, the Parliament and the Council.

3.1.4 Incorporation into the EEA Agreement

The two legislative acts constituting the CRD IV package will be directly binding for all EU Member States, including, of course, Denmark, Finland and Sweden. The CRD IV package will not apply directly for Norway and Iceland, as non-Member States. The CRD IV package is EEA relevant, however, and is planned to be included in the EEA Agreement by a corresponding amendment to the relevant annex of the EEA Agreement. Once an EEA-relevant act of EU legislation is incorporated into the EEA Agreement, Norway and Iceland are committed to implement or incorporate the act into their national legislation.[4]

However, including the CRD IV package in the EEA Agreement may involve some challenges. The decision-making process in the EEA Agreement is characterised by its two-pillar structure. The EEA EFTA States have not transferred any legislative competencies to the EEA institutions and they are unable, constitutionally, to accept direct decisions by the Commission or the European Court of Justice. To cater for this situation, the EEA Agreement established EEA EFTA bodies to match those on the EU side. The EEA EFTA States take all decisions by consensus as opposed to the EU side where decisions related to EEA legislation are normally taken by majority vote.

The Commission and EBA are given extensive responsibilities under the CRD IV framework. According to the two-pillar structure in the EEA Agreement, EU institutions such as the Commission and the EBA cannot be conferred any decision-making powers in the EFTA pillar. These challenges must be therefore solved through an adaption text when incorporating CRD IV-package into the EEA Agreement.

3.2 Harmonisation, flexibility and reciprocity

3.2.1 Harmonisation of prudential requirements in the EEA

In June 2009, the European Council, supported by the European Parliament, called for the establishment of a European single rule book applicable to all financial institutions in the EEA single market. The European Commission followed up on this call when it presented its

[4] The general principles for incorporating EU legislation into the EEA Agreement are laid down in Article 102 (1) of the EEA Agreement. The EEA Joint Committee is to take an amendment to the EEA Agreement as closely as possible to the corresponding EU legislation, with a view to permitting simultaneous application in the EU and in the EEA/EFTA States. All the EEA/EFTA States have to agree for the Committee to take a decision. The contracting parties have not transferred any legislative powers to the EEA Joint Committee. It has therefore been necessary to regulate the situation in which, according to their constitutions, an EEA JCD can only be binding on one or the other contracting party after it has been approved by parliament or by referendum. Where one of the contracting parties needs to fulfil constitutional requirements and notification of fulfilment is received after the stated date of entry into force of the JCD, the confirmed date of entry into force will be the first day of the second month following the final notification. For more information on incorporation of EU legislation into the EEA Agreement: http://www.efta.int/eea/eea-institutions/eea-decision-making.aspx

CRD IV proposal in July 2011. The Commission pointed out that the current CRD leave room for significant divergences in national rules, and asserted that this has created a regulatory patchwork, leading to legal uncertainty, enabling institutions to exploit regulatory loopholes, distorting competition, and making it burdensome for institutions to operate across the single market. On this basis, the Commission suggested removing current national options and discretions from the CRD to achieve full harmonisation. The goal is to ensure uniform application of the Basel III standards, to close regulatory loopholes and to contribute to a more effective functioning of the single market. The Commission also pointed to a need to ensure that institutions' financial situation is more transparent and comparable, referring to the current lack of transparency being an obstacle to effective supervision and market confidence. According to the CRD IV proposal, Member States would only be allowed to apply stricter requirements where these are needed on financial stability grounds or because of an institution's specific risk profile.

While some countries supported the Commission's full harmonisation approach, others called for more national flexibility The EEA/EFTA countries, the European Central Bank and the European Systemic Risk Board also voiced their preference for more national flexibility. Arguments in favour of more flexibility have, for example, been expressed in a letter of May 2011 from Sweden, the United Kingdom and five other member states to Commissioners Barnier and Rehn, and a letter of January 2012 from the EEA/EFTA countries to the European Commission.

Those in favour of the full harmonisation approach often point to the high degree of financial and monetary integration in the EEA, and that joint policies are necessary to safeguard financial stability at both the national and European level. The Commission argued, for example, that decisions on capital requirements are felt by all countries in the single market, and that it is not realistic to believe that unilateral action brings safety in this context. If an individual country were to increase capital requirements for domestic institutions, institutions from other countries can continue to provide their services with lower requirements unless other countries follow suit. This can give rise to regulatory arbitrage, where institutions affected by the higher capital requirements could relocate and continue to provide their services in the original country through a branch. In addition, institutions could be encouraged to concentrate risky activities in the countries with the lowest requirements.

While lower capital requirements is typically considered a competitive advantage for institutions, due to assumptions of lower overall funding costs, the opposite may in some instances also be true. The Commission and others in favour of the full harmonisation approach have suggested that institutions subject to higher minimum capital requirements may very well have a competitive advantage over other countries' institutions, and that this could force other countries to increase their requirements regardless of the economic need for such higher requirements. It is also argued that higher capital requirements in a home country could lead to of institutions transferring capital from a host to the home country, which could imply deleveraging of the institutions' host country activities, and thus in turn a negative impact on employment and growth in the host country.

Moreover, different rules in different countries can imply higher than otherwise costs for cross-border financial groups, as they would have to comply with requirements of several jurisdictions simultaneously.

3.2.2 National flexibility considerations

As mentioned above, the Commission's CRD IV proposal included some allowances for stricter requirements at the national level, i.e. where this is needed on financial stability grounds or because of an institution's specific risk profile. The CRD IV texts agreed in the Council common approach and the ECON Committee's report expand on national flexibilities. Taken together, the main areas of national flexibilities on capital requirements in the various CRD IV texts may be summarised as in Table 3.2.

Table 3.2 Main areas of national flexibilities in the CRD IV package

Flexibility	Proposed by
Retained powers to impose additional capital requirements under the Pillar II supervisory process	Commission, Council, ECON Cmte.
Earlier implementation of the CRD IV capital definitions and/or minima	Commission, Council, ECON Cmte.
Setting of the counter-cyclical capital buffer requirement rate	Commission, Council, ECON Cmte.
Setting of the capital conservation buffer requirement rate	Commission, Council, ECON Cmte.
Setting of the systemic risk buffer requirement rate	Council
Setting of the systemic buffer requirement rate (SIFI requirement)	ECON Cmte.
Adoption of temporary national measures to address macro-prudential or systemic risk (including higher capital requirements)	Council, ECON Cmte.
Higher risk weights for exposures secured by mortgages on immovable property	Commission, Council, ECON Cmte.

Those calling for more national flexibility in the CRD IV package often refer to the varying sizes and compositions of the financial sectors across European countries, and that this means that risks are not uniformly distributed. Risks reflect, it is argued, the composition and the relative size of each individual country's financial sector, and countries should therefore retain the ability to set higher capital and liquidity requirements than the EU minima in order to safeguard national financial stability and taxpayers' money. For instance, the EEA/EFTA countries point to the high cost from banking crises, not least for small, open economies, in a letter of January 2012 to the EU. The letter also states the following:

> *"While the financial markets are global, eventual problems in the banking sector in a country must be dealt with by the national authorities of that country. Each country's national authorities therefore have a clear responsibility and a clear incentive to prevent a crisis in their own banking system."*

Generally, national flexibility advocates also point out that the macro-economic situation differs, and will presumably continue to differ, across European countries, implying that it is important to be able to address specific national circumstances with adequate prudential regulation.

The countries in favour of more flexibility generally support a minimum harmonisation approach, and emphasise that the new Basel III/CRD IV capital minima may be suboptimal from a macroeconomic perspective, not least for small economies with concentrated banking sectors. It is also pointed to a possibility of positive externalities on neighbouring countries when higher capital requirements are introduced in one country, as the banking sector becomes more stable and less prone to financial disruptions.

Moreover, the national flexibility advocates make a clear distinction between the use of Pillar I and Pillar II requirements, and insist that flexibility in the application of Pillar I

measures are necessary. Since additional capital requirements imposed as supervisory Pillar II measures are not public information, they may impede transparency. Pillar II measures can also be legally challenged by the institutions, and will typically not be applied permanently, but rather subject to frequent reviews.

3.2.3 Reciprocity and home-host regulation

Among the key features of the proposed CRD IV counter-cyclical buffer requirement, is that its level shall be set by national authorities, and that other Member States have to recognise and apply the requirement (up to a buffer rate of 2.5 per cent) to institutions active in a member state setting the requirement, cf. section 4.2 below. That is, the requirement shall apply for exposures incurred in the member state setting the requirement, regardless of whether the exposures are incurred by institutions domiciled there or by branches of other Member States' institutions.

In general, such a *reciprocity* construction may allow individual states the flexibility to set stricter prudential requirements for domestic exposures in accordance with specific national circumstances, without conflicting with the "level playing fields." There would, for example, be little room for regulatory arbitrage, as requirements would follow exposures (all institutions would compete on equal terms in individual markets). Complying with different requirements in different countries could imply higher administrative costs for cross-border financial groups, but this may be curtailed if the variation in requirements is limited to harmonised policy tools and definitions, e.g. so that only rates differ across countries.

As mentioned, reciprocity is formally included in the CRD IV texts, *inter alia* for capital requirements for real estate exposures and for a counter-cyclical buffer requirement. In other areas where Member States looks to retain the flexibility to impose stricter prudential requirements than EU minima, it appears that there will be room for voluntary reciprocity, i.e. through bi- or multilateral agreements between Member States. Such voluntary reciprocity is for instance specifically introduced for the systemic risk buffer requirement in the Council's general approach.

Box 3.1 What is reciprocity?
The term *reciprocity*, i.e. the characteristic of being *reciprocal*, can have several interpretations. In this report, the working group uses the term reciprocity to label a mechanism whereby a certain prudential requirement will apply for exposures incurred in the country setting the requirement, regardless of whether the exposures are incurred by institutions domiciled there or by branches of foreign institutions domiciled within the reciprocity area. The countries within a reciprocity area will mutually recognise and apply the prudential requirement for domestic institutions for the institutions' exposures incurred in the country setting the requirement.

3.3 CRD IV in the Nordic countries

3.3.1 The Nordic aspect

Nordic financial markets are quite integrated on the supply side. Most foreign institutions operating in the Nordic countries are domiciled in other Nordic countries; see Chart 3.1 below. Foreign institutions domiciled outside the Nordic area have a very small share of the Nordic credit market. Not even in Norway, where the presence of non-Nordic institutions is most visible, does the market share of non-Nordic institutions exceed 2 per cent; cf. the chart.

Financial stability in the Nordic region may therefore be said to depend on the soundness of financial institutions in the Nordic region as a whole. The competitive environment on the supply side in the Nordic financial markets may furthermore raise barriers for stricter rules in one or some countries. Some Nordic financial institutions have expressed concern over prospects of differentiated rules across the Nordic region, and have pointed to a potential competitive disadvantage for institutions subjected to stricter rules.[5] Stricter rules in one Nordic jurisdiction may for instance contribute to a shift towards other Nordic institutions for credit supply. The residential mortgage market may be particularly susceptible for such shifts, as residential mortgages are fairly standardised products, and subject to considerable competition among domestic and foreign institutions.

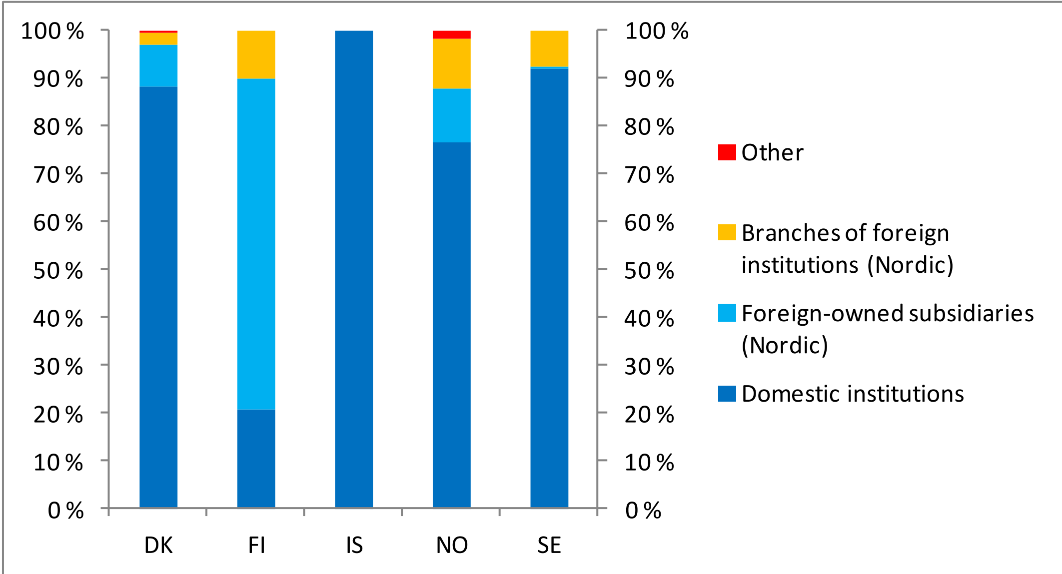

Chart 3.1. Per cent of credit institutions' total assets in domestic institutions, subsidiaries owned by non-domestic Nordic institutions, branches of non-domestic Nordic institutions, and other institutions (i.e. foreign institutions' activities). Per yearend 2010/2011
Source: The Nordic ministries/the working group

The Nordic countries cooperate on financial regulation and supervision, both at the supervisory and ministerial level. In addition, the Nordic countries have, among other things, concluded an agreement with the Baltic countries concerning cooperation to prevent, handle and resolve potential problems in banks operating across the Nordic-Baltic area.

For the purposes of this report, it may be noted that there are differences between the Nordic countries in regard to the role and formal powers of the financial supervisory authorities. Some of the supervisory authorities are for instance more independent of the responsible ministry than others. This may affect the level of influence of the ministries. Further, the existing capital requirements directives leave open several implementation choices over which home and host supervisors may differ. In certain areas, this may require a closer cooperation and coordination between supervisory authorities. Moreover, the Nordic

[5] Stricter rules e.g. in terms of higher capital requirements may on the other hand also be beneficial also for institutions' competitiveness (through improved solvency), even though it could affect costs and market shares in the shorter run.

supervisory authorities also have different ways of practising Pillar II measures under the existing capital adequacy framework.

3.3.2 National challenges and implementation plans

3.3.2.1 Denmark

Main challenges
Implementation of the LCR as originally defined by Basel Committee in December 2010 would by far have been the greatest challenge for Denmark due to the Danish credit mortgage system based on the issuance of mainly covered bonds. In the Basel III standard covered bonds are by definition not considered as highly liquid assets (level 1) and thus incur a 15 per cent haircut. Furthermore, the standard has a 40 per cent limit for the level 2 assets with a specific unwound-mechanism and both elements introduce major problems for the Danish credit institutions.

This has to do with the fact that Danish covered bonds due to their characteristics as highly liquid and secure instruments are widely used for liquidity risk management in Denmark. The Basel III standard penalises these assets – despite the fact that they empirically have shown to be highly liquid also during periods of crisis. On the contrary, government bonds are by definition regarded as highly liquid assets in the Basel III standard, but the current volume of available government bonds are not sufficient for the LCR to be fulfilled by Danish credit institutions and acquiring government bonds in other currencies implies risks which could be avoided.

Altogether, the proposed Basel III standard on liquidity could have a major impact on the Danish housing market and financial stability unduly punishing stable functioning business models over time.

However, in the current CRD IV framework as agreed at ECOFIN on 15 May 2012 a different approach is chosen, which is very close to the original Commission proposal. In this case the final LCR standard will be calibrated through a delegated act by the Commission. In that regard EBA shall report to the Commission on the definitions of liquid assets. The report from EBA shall test a number of different assets based on their objective merits as liquid assets. The European Parliament has chosen a similar approach. It is therefore the expectation that this approach will also be enshrined in the final regulations.

The NSFR as defined in Basel III will also pose a challenge for the mortgage credit banks due to their large supply of 1-year flexible-rate mortgage loans in which the funding of the loan is short (1 year) whereas the loan is often given for 30 years. Such loans are likely not to be eligible for the calculation of the NSFR which could lead to a phasing out and thus higher interest rates for house owners. However, in the Council's general approach it is still not decided whether and it what form the NSFR will come into force in the EU. This will be decided in 2017 through co-decision. The European Parliament on the other hand wants the NSFR to come into force from 2013 and then to be specified through a delegated act when Basel has finalised its calibration. In that regard, the exact impact on the Danish market is still unclear.

The strengthening of minimum capital requirements within the CRD IV will not pose any major challenges for the Danish credit institutions. The individual domestic credit institutions

are required – and will continue to be required – to disclose their pillar II capital requirement according to the Danish Financial Business Act (*lov om finansiel virksomhed*). In recent years, the Danish FSA has for most Danish banks required total capital ratios well above the minimum capital requirement of 8 per cent. As per end-2011 the weighted average total capital ratio of the Danish banks[6] was 20 per cent, the Tier 1 capital ratio 17.2 per cent and the CET 1 ratio approx. 14 per cent.

The current proposal regarding the leverage ratio seems not to lead to any major challenges either. However, the measure of non risk-weighted assets in the denominator is not yet finally defined and may potentially create some challenges for the largest banks or for banks with relatively large credit mortgage assets.

Implementation plans

Currently, Denmark does not plan to accelerate the application of any of the new CRD IV prudential requirements beyond the proposed phase-in arrangements. However, two committees have been established and their conclusions may affect the way that Denmark implements the CRD IV.

The committee called *Udvalg om struktur for Finansielt Tilsyn i Danmark*[7] is working on a proposal for a macro-prudential set up in Denmark and the report of the committee is expected this summer. Another committee, *SIFI-udvalget,*[8] is currently discussing criteria, requirements and resolution for systemically import institutions in Denmark. The report from *SIFI-udvalget* is expected by the end of 2012.

With regard to the LCR and NSFR, reporting to the Danish FSA for the largest credit institutions has already been established. Furthermore, one of the criteria in the 'supervisory diamond'[9] is a stable funding measure, a simplified NSFR, which will enter into force in 2013.

Legal process

In Denmark, the CRD IV Directive is implemented in the Financial Business Act (*lov om finansiel virksomhed*) and administrative rules (*bekendtgørelser*) issued under the Act. The implementation will expectedly result in changes to a considerable extent.

As in the other Nordic countries, the legislative process in Denmark extends over a longer period of time. A bill to implement the Directive in the Financial Business Act is expected to be sent out for consultation in public and with stakeholders in the fourth quarter of 2012 and then submitted to the Danish Parliament (*Folketinget*).

Denmark expects to implement all relevant provisions now and do not expect to postpone parts of the implementation. Denmark has so far not implemented directive provisions that are directed only to Finanstilsynet and other authorities, i.e. provisions that do not regulate either

[6] The Danish credit mortgage banks not included.

[7] In the autumn of 2011, the Minister of Business and Growth asked the committee to deal with issues related to the managing of systemic financial risks and the potential need for establishing a Systemic Risk Board in Denmark.

[8] In January 2012, the Minister of Business and Growth established a committee on systemically important financial institutions (SIFIs).

[9] For further information on the supervisory diamond: www.finanstilsynet.dk/tilsynsdiamant

citizens or businesses. It is currently considered whether this procedure shall also be applied with regard to the CRD IV rules as well as there are considerations about a more fundamental change in the legislative structure of the regulation of financial businesses in Denmark.

3.3.2.2 Finland

Main challenges

For Finland, it is of utmost importance to be able to maintain extensive national legislation on co-operative networks. The CRD IV framework may, at worst, result in major restructuring of the co-operative sector in Finland, with potential adverse impact on stability. Moreover, if it will not be possible to maintain a capital structure based on having two or more classes of shares with different voting rights and distributions, the central institution of the Finnish co-operative network (and some other banks) will face major challenges. If the non-voting capital instruments of Finnish co-operatives no longer will be allowed, there is the additional challenge of establishing new rules in a way which makes it possible for the co-operatives to raise money from the market. It may prove difficult to design such capital instruments that are attractive in the market under the limitations imposed by the proposed regulation.

Other challenges mainly relate to the implementation of the requirements on the counter-cyclical buffer, especially ensuring the correct methodology and timing in determining counter-cyclical buffers. Finland does not foresee any other major challenges regarding the new capital framework.

Implementation plans

The CRD IV directive is not likely to be transposed into Finnish legislation until mid-2013. This means that for a few months the regulation would have to be applied in spite of existing national law. A new Act on Credit Institutions must be adopted to carve out the prudential requirements and to introduce, among other things, the new regimes on corporate governance, sanctions and buffers. Significant amendments to the Financial Supervision Act and a large number of technical adaptations to other pieces of legislation are required as well. A new governmental decree is likely to be needed to implement the details of the buffer regime.

Finland does not expect to accelerate the application of any of the new CRD IV prudential requirements beyond the proposed phase-in arrangements.

Legal process

A first complete draft government proposal is foreseen to be distributed for public consultation in late August or early September 2012, so that it could be adopted by the Government before the Finnish Parliament starts its spring season in early February 2013.

The existing government decrees must be replaced by new ones. In this context there may be a need to designate the Ministry of Finance as a competent authority for the purpose of certain articles in the proposed EU regulation that include *de facto* Member State options allowing the competent authorities to apply alternative rules (such as the alternative treatment of certain exposures in the large exposures regime). The entire set of Finnish FSA regulations must also be revised and most of them abolished.

3.3.2.3 Iceland

Main challenges

The Icelandic banking system is characterised by the dominance of three large banks, established following the crisis in 2008, with a combined market share of over 95 per cent. The banking licenses granted to the banks in August 2009 were conditioned on a minimum tier 1 capital ratio of 12 per cent and a total capital ratio of 16 per cent, well above the Pillar I requirement of 8 per cent. Both ratios were to be in place for at least three years unless otherwise decided by the Icelandic Financial Supervisory Authority (Fjármálaeftirlitið, FME). The banks all have capital ratios well above the minimum requirement set by the FME.[10] In light of this fact, and a relatively conservative capital definition, the Icelandic banks are well positioned to fulfil the capital requirements established in the new CRD IV framework. Iceland is, however, of the view that the minimum capital requirements are too low from a macroeconomic standpoint. In the absence of other solutions, Iceland will strive to align the three proposed capital buffer requirements to secure higher – and economically more optimal – capital requirements.

The introduction of a leverage ratio does not pose a challenge to the Icelandic banks due both to their high capital ratios and their asset structure, characterised by a large share of corporate loans which usually have higher risk weights than lending to individuals. It is very unlikely that the leverage ratio will be a binding constraint on the banks or other supervised undertakings.[11] No Icelandic banks employ the IRB approach to calculating risk weights for capital adequacy purposes.

The LCR is not expected to pose challenges to the Icelandic banks.[12] The banking sector has been highly liquid in the last three years.[13]

Implementation plans

Iceland is currently considering whether to implement the Basel III minimum capital requirements in advance of the proposed EU deadlines. A decision will be taken in the second half of 2012, once the final CRD IV framework is clear. The possibility of mandating early publication of the leverage ratio is also being considered.

Iceland will review how the CRD IV implementation may best safeguard economic and financial stability. The preparation and implementation of the countercyclical buffer and other similar tools may play an important role in this regard. The questions of which institution to mandate with preparing the buffer guide and its application are among those to be considered by a high-level committee of domestic and international experts established by the Minister of Economic Affairs in March 2011. The committee is to present its proposals in the second half

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[10] Per 2011, the tier 1 (and total) capital ratios for three largest Icelandic banks were 21.9% (and 21.4%) for Landsbankinn, 19.1% and (22.6%) for Íslandsbanki, and 16.4% (and 21.2%) for Arion banki.

[11] The Government owned Housing Financing Fund might have to be excluded from the rule. It does currently not have to fulfill the minimum capital requirement, but has a long-term target risk weighted capital rate of 5%.

[12] Today, the large commercial banks in Iceland are required to hold liquid assets equal to 20% of total deposits and cash and cash equivalent assets of at least 5% of sight deposits. Moreover, the banks are required to hold liquid assets in excess of the liabilities maturing in the next three months.

[13] Icelandic banks currently holds liquid assets accounting for between 150 and 200 % of short-term liabilities and 40% of total deposits. This is in part due to large amounts of assets held by foreign investors that became locked in as capital controls were imposed. Foreign investors own around 10% of all deposits. As the controls are eased, the authorities will monitor the effect on bank liquidity.

of 2012. The proposals are to form the foundation for a new financial market draft legislation to be presented to Parliament before year-end 2012.

Liquidity management remains a chief concern in Iceland, not least as the capital controls are being lifted. A working group composed of experts from the Central Bank of Iceland and the FME have started a revision of the existing liquidity rules and requirements set by the authorities, building on the work done by the Basel Committee and the EBA. Most probably, the new liquidity framework will contain the LCR, a maturity ladder (ML) and some domestic version of the NSFR, and come into effect on 1 January 2013 or 1 July 2013. Moreover, the FME will update its guidelines on liquidity management (issued in 2010).

Legal process
CRD IV will be transposed into the Icelandic legal framework by amendments to the Act on Financial Undertakings and rules issued by the competent supervisory authority following its incorporation into the EEA agreement.

The transposition of CRD IV into EEA law will also require a solution to a more horizontal issue on the relations between the new European Supervisory Authorities (ESAs) and the EEA/EFTA states. With regards to Iceland, the challenge of fully aligning the EEA Agreement with the new supervisory structure will be solved if Iceland joins the EU following the on-going accession negotiations and a national referendum.

3.3.2.4 Norway

Main challenges
In Norway, high household debt levels, combined with high and rising housing prices, pose a significant risk to financial stability.[14] It is therefore important for Norway to retain sufficient flexibility in the new EU/EEA rules to impose higher capital requirements where this is appropriate based on financial stability considerations. Norwegian authorities are also concerned about the increasing reliance on internal risk models (IRB models) for the calculation of capital requirements for mortgage loan exposures. The historical data used in models may not be suitable proxies for future risk, as they do not account for changes in fundamental risk factors, such as increased indebtedness in the household sector. For Norway, it is important to look into how this issue can be addressed, perhaps by using the standardised approach risk weights or by establishing floors for the parameters used in IRB models, discretionary risk weight add-ons or other measures. An effective measure already in place is of course the Basel I floor, which in Norway will be enforced until further notice.

The strengthening of minimum capital requirements within the CRD IV will not pose challenges for Norwegian credit institutions. As per yearend 2011, Norwegian banks had an average CET1 capital ratio of 11 per cent.

The funding structure of Norwegian banks and mortgage companies has become more robust over the last years, but short-term wholesale funding still accounts for a fairly large portion of

[14] Norwegian housing price growth has been high the past 15 years, and households' debt-to-disposable income ratio has reached an all-time high of almost 200 per cent. Norwegian households are vulnerable to higher interest rates, loss of income and/or a drop in prices for residential property, while Norwegian financial institutions are vulnerable to losses stemming from financial problems in the household sector, be it directly or via lower household demand.

total wholesale funding. Whilst it is primarily the larger banks that are directly dependent on wholesale funding and to a great extent on foreign sources of funding, turbulence in international funding markets may spread quickly to the smaller banks as well, because the larger banks are important funding sources for the smaller banks. Norwegian banks have since 2008 largely exploited the potential for funding new lending by transferring residential mortgages to residential mortgage companies (which issue covered bonds). Norwegian authorities have stressed the importance that the banks reduce their liquidity risk. Early adaption to new funding and liquidity requirements will reduce banks' vulnerability to turbulence in funding markets and the phasing out of Norwegian authorities' extraordinary liquidity measures (introduced during the international financial crisis).

The LCR requirement may pose some certain challenges for Norwegian institutions due to the limited availability of liquid assets in NOK and the treatment of deposits in the LCR. The Norwegian markets for both government bonds and covered bonds are relatively small.[15] A conservative interpretation of the CRD IV proposals implies that no NOK denominated securities, other than government paper, will qualify for the LCR. The Norwegian authorities believe that the NSFR would be less challenging for Norwegian institutions. However, Norwegian banks rely heavily on deposits for funding, and the treatment of various types of deposits will have a large impact on Norwegian banks' NSFR figures.

Implementation plans

A new Act on financial undertakings and financial groups, together with detailed rules that enables the implementation of CRD IV, may enter into force on 1 January 2013. Norway will then consider early implementation of the new CRD IV capital minima, the new buffer requirements and perhaps other measures. The soundness of Norwegian financial institutions and the state of the Norwegian economy imply that early implementation of new capital requirements is both feasible and desirable.

Finanstilsynet (the Norwegian financial supervisory authority) has already imposed LCR and NSFR reporting for Norwegian credit institutions.[16] Norway anticipates the finalised LCR/NSFR design and the Basel Committee discussions on alternative solutions for countries with small sovereign bond markets, and will consider early implementation of the LCR/NSFR.

Norway is working to establish a new system for macro-prudential supervision, including a procedure and designated authority for setting the counter-cyclical capital buffer rate. A public consultation has been held on a working group proposal, and the Ministry of Finance has presented its views in a report to the Storting. The Ministry envisages itself taking on the role as designated authority until some experience with this new tool is gained, while Norges Bank will be given primary responsibility for developing the basis for the counter-cyclical capital buffer requirement decision.

[15] Due to the Norwegian government's favourable financial position, the outstanding amount of NOK denominated government securities is small. In 2010, the total outstanding amount of Norwegian government securities was equivalent to around 24% of GDP, which is low compared to other Nordic countries. Moreover, there is reasonable to assume that the amount available to Norwegian banks will be lower than the outstanding balance due to a large amount "locked up" as hold to maturity investments by foreign investors, life insurance companies and pension funds. The Norwegian market for covered bonds is new and small compared to similar markets in other Nordic countries, and probably less liquid.

[16] In addition, Norwegian authorities often encourage institutions to acquire more stable funding, to reduce their vulnerability to deterioration in international funding market conditions.

Legal process
Norwegian authorities aim to propose to the Storting a new Act on financial undertakings and financial groups in fall 2012. The purpose of the new act is primarily to modernise and integrate the current institution-specific legislation into one law, but the Ministry of Finance will also propose provisions in the law authorising the Ministry to stipulate detailed rules to implement, *inter alia*, the CRD IV and Solvency II frameworks. The act proposal will be based on the Banking Law Commission's draft act, presented in the report NOU 2011: 8 New Financial Legislation. There was a public consultation on the Banking Law Commission's draft law in 2011. This was supplemented in October 2011 by a consultation on a proposal from Finanstilsynet, based on the European Commission's CRD IV proposal of 20 July 2011. Detailed rules to implement CRD IV will probably be drafted and subject to a public consultation later in 2012 or in 2013.

As mentioned above, the CRD IV package is not binding for Norway until it is incorporated into the EEA Agreement. An EU regulation is not formally binding for Norway before it has been incorporated into the EEA Agreement. However, Norway may of course adopt a national regulation containing materially the same rules as the EU regulation, pending the incorporation of the EU regulation into the EEA Agreement. In the case of the comprehensive CRD IV regulation, however, it may be challenging to translate into Norwegian the text of the EU regulation before 1 January 2013.

3.3.2.5 Sweden

Main challenges
The timeline set out by the Basel Committee and the G20, which the EU has committed to follow, is indeed challenging. In the best-case scenario (time-wise, not necessarily content-wise), there will be an agreement between the Council and the European Parliament during the Danish presidency. The standard time-span for an ordinary legislative process in Sweden is 12-18 months, implying that adapting the present legislation[17] during the fall 2012 in order to be compatible with the key parts of the CRD IV framework is a challenge (given that there is a complete package agreed no later than1 July).

From an industry perspective, the main reservation about CRD IV is the higher capital requirement ambition the Swedish government has presented. The four largest banks in Sweden argue that this will impede on a European level playing field and place them at a competitive disadvantage. When it comes to actually attaining the stricter levels in 2013 and 2015, the four systemically important banks already fulfil to 10 per cent CET1 requirement. According to the Riksbank's financial stability report in June 2012, their CET1 levels as share of risk weighted assets range from 10.5 per cent to 14.8 per cent, calculated under Basel III rules. Under moderate profit projections for 2012-2015, these banks should be able to attain also the 12 per cent level by 1 January 2015.

The Swedish FSA's estimate is that the non-systemically institutions should have little problems living up to the stricter requirements following from Basel III already on 1 January 2013. The main challenge is for smaller credit institutions that fear the new regulatory framework will imply a prohibitively excessive legal burden on their limited activities.

[17] Obviously, the regulation, when entered into force, will replace the relevant national legislation.

However, because of their limited activities, they will be able to disregard parts of the CRD IV. In addition, the bulk of what CRD IV is doing is putting a large part of two existing directives into a regulation. Therefore, CRD IV does not necessarily imply a much heavier burden on institutions (not considering the effects of introducing the Basel III agreement).

Implementation plans

If the EU adopts the CRD IV framework before 1 July 2012, then it will be possible for the regulation to enter into force in the EU/EEA on 1 January 2013. Under such circumstances the Swedish government's plan is to, besides enabling the Swedish FSA to exercise the new supervisory powers given to competent authorities under the regulation, focus on implementing the key parts of the directive into national law at an enhanced pace during the fall of 2012.

The focus would be on getting the framework governing the buffers (i.e. the capital conservation buffer and systemic buffer, respectively) in place so that they can be activated at the same time as when the regulation enters into force on 1 January 2013. This means that Sweden intends to fast-track the implementation of the buffers compared to the CRD IV/Basel III timeline.[18] In addition, the forthcoming legislative process will make the necessary regulatory "tools" and mandates available to the Swedish FSA so that the regulation can be applied and be compatible with Swedish law as from 1 January 2013.

Finansinspektionen (the Swedish financial supervisory authority) will in June 2012 propose the introduction of a Swedish version of the LCR from 1 January 2013. The Swedish version of the LCR will essentially be an increased and more specified reporting requirement, and include quantified liquidity requirements similar to the LCR outlined by the Basel Committee and in the CRD IV texts. The Swedish LCR will imply a quantitative requirement both at the aggregate level, and in USD and EUR, respectively. The latter is motivated by the fact that the large Swedish banks have almost a quarter of their overall funding in foreign currency, of which USD and EUR dominate. There already exists a reporting requirement regarding liquidity in Sweden for institutions with total assets of more than SEK 5 billion. The new requirement will apply to a smaller number of institutions than the current reporting requirements, and those affected will be excluded from the present reporting requirements.

Other parts of the CRD IV will likely be implemented at a later stage, notably the corporate governance and the administrative sanction parts as well as the counter-cyclical buffer. In order to get these parts of the CRD IV implemented into national legislation in the best possible way, the Swedish government has set up a commission to analyse further what changes in the Swedish legislation are needed.[19] This commission will also consider if there is a need to introduce a special procedure for dealing with administrative sanctions. If it is deemed to be appropriate, the commission is requested to present draft proposals for how such a procedure should be designed. The commission will also analyse which authority should be given the assignment to set the counter-cyclical buffer.

The broader institutional set-up of Sweden's macro-prudential oversight is currently being investigated by another commission, *Finanskriskommittén,* due to report to the Government

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[18] Note that the systemic buffer is neither a "Basel-buffer" nor an obligation under the CRD IV.

[19] Fi 2012:05 Utredningen om kapitaltäckningsregler.

later this year.[20] This may also affect how Sweden chooses to implement the CRD IV framework.

Legal process

Implementing the CRD IV framework is likely to be an extensive legal process in Sweden. Partly because the Swedish legislative procedure is time-consuming, as it usually takes 12-18 months to complete and includes a public consultation period of not less than three months. Despite the extensive scope of legal acts affected by the new framework, the commission analysing the overall implications of implementing CRD IV is expected to deliver its results, including drafts of the necessary legislative changes, on 1 October 2012.

[20] More concretely, this committee is among other things asked to give further considerations to the different mandates, as far as financial stability is concerned, of the Riksbank, National Debt Office, the Ministry of Finance and the Swedish FSA and how these government bodies can improve copperation, as well as improvements to the framework for the Central Banks's conduct of financial stability, including the provision of liquidity support and its role of promoting financial stability.

4 The CRD IV framework and possibilities for Nordic coordination

4.1 Liquidity and funding requirements

4.1.1 The European Commission's proposal

Liquidity coverage requirement (LCR)
As mentioned introductorily, the European Commission's regulation proposal includes the liquidity coverage requirement (LCR), which is intended to improve the short-term resilience of credit institutions' liquidity risk profile. A general, *qualitative* version of the LCR shall according to the proposal apply from 1 January 2013. This states that institutions shall hold high-quality liquid assets equal to or greater than net liquidity outflows under stressed conditions, cf. article 401 of the regulation proposal. The requirement is accompanied by an obligation to report to national authorities the elements that are needed to verify that institutions have adequate liquidity coverage. EBA shall develop uniform reporting formats (technical standards) for this purpose, which may be adopted by the Commission.

According to its proposal, the Commission will have a power to specify a *quantitative* LCR, based on the outcome of an observation and review period and international developments, which may apply from 1 January 2015, cf. article 444 of the regulation proposal. The quantitative LCR is to be based on reporting requirements detailed in articles 403-413 of the regulation proposal and an EBA report on uniform definitions of high-quality liquid assets. The articles govern, *inter alia*, the definition and valuation of liquid assets, and the calculation of liquidity inflows and outflows.

Moreover, the Commission's proposal implies that the LCR within financial groups will apply for every individual institution. Supervisory authorities may instead allow a consolidated requirement for the group as a whole if, *inter alia*, the institutions in the group are legally committed to support each other and have the ability to do so. If a group has institutions in several Member States, all affected national supervisors must agree together to allow a consolidated requirement. If there is disagreement, each national supervisor of an individual institution shall decide alone about whether the LCR should apply for the individual institution.

Member States may impose a liquidity coverage requirement at the national level as they find appropriate until the Commission's LCR is introduced, so long as the national measure is not inconsistent with provisions in the regulation.

It deserves mention that the Basel Committee, in the *Basel III standards*, has provided a more specific definition of the high-quality liquid assets that may be included in the liquidity coverage *ratio*. The Committee distinguishes between so-called level 1 and level 2 assets, where the latter can only comprise up to 40 per cent of the stock of high-quality liquid assets for the purpose of calculating the LCR. All level 1 assets can be included. According to the Basel III standards, level 1 assets are limited to the following:

- Cash.
- Central bank reserves (that can be drawn down in times of stress).
- Claims (i.e. securities) on or claims guaranteed by sovereigns, central banks, public sector entities, the BIS, the IMF, the European Commission, or multilateral development banks. The inclusion of such claims are however subject to certain conditions (e.g. 0 per cent risk weight under the standardised approach; traded in

large, deep and active markets; proven reliability; and not an obligation of a financial institution or any of its affiliated entities).

- For non-0 per cent risk-weighted sovereigns: Sovereign or central bank debt securities issued in domestic currencies by the sovereign or central bank in the country in which the liquidity risk is being taken or in the bank's home country.
- For non-0 per cent risk-weighted sovereigns: Domestic sovereign or central bank debt securities issued in foreign currencies, to the extent that holding of such debt matches the currency needs of the bank's operations in that jurisdiction.

Level 2 assets are limited to the following (also, a minimum 15 per cent "haircut" is applied to the market value of each level 2 asset):

- Claims (i.e. securities) on or claims guaranteed by sovereigns, central banks, public sector entities or multilateral development banks. The inclusion of such claims are however subject to certain conditions (e.g. 20 per cent risk weight under the standardised approach; traded in large, deep and active markets; proven reliability; and not an obligation of a financial institution or any of its affiliated entities).
- Corporate bonds and covered bonds. The inclusion of such bonds are however subject to certain conditions (e.g. not issued by a financial institution or affiliated entity; have a credit rating of at least AA-; traded in large, deep and active markets; and proven reliability).

The Basel Committee has acknowledged that some jurisdictions may have an insufficient supply of level 1 and level 2 assets in their domestic currency to meet banks' demand owing to the LCR. The Committee has therefore stated that it will use the observation period until 2015 to, *inter alia*, develop alternative options for banks in such jurisdictions. In the Basel III standards issued in December 2012 the Committee lists the following potential options to be finalised during the observation period:

- Contractual committed liquidity facilities from the relevant central bank, with a fee.
- Foreign currency liquid assets (banks would be allowed to hold liquid assets in a currency that does not match the currency of the associated liquidity risk, provided that the resulting currency mismatch positions are justifiable and controlled).
- Additional use of level 2 assets with a higher haircut (i.e. haircuts above the haircuts that apply to level 2 assets included in the 40 per cent quota).

Net stable funding requirement (NSFR)

The Commission's regulation proposal does not include a net stable funding requirement (NSFR), but rather a reference to the Basel Committee's observation period until 2018. The Commission plans to prepare a NSFR legislative proposal sometime during this observation period. The proposal does, however, include reporting requirements on stable funding, cf. articles 414-415 of the regulation proposal. Institutions shall report to the supervisory authority on items providing and requiring stable funding.

In the *Basel III standards*, the objective of the net stable funding *ratio* is to ensure that long-term assets are funded with at least a minimum amount of stable liabilities, and to limit over-reliance on short-term wholesale funding. The ratio is defined as "available stable funding" to "required stable funding," and shall according to the Basel III standards exceed 100 per cent. In this context, "stable funding" is defined as the funding expected to be reliable sources of

funds over a one-year time horizon under conditions of extended stress. Moreover, the Basel III standards include comprehensive definitions of what is to be considered “available stable funding” and “required stable funding.”

4.1.2 Council and Parliament ECON Committee texts

The CRD IV texts adopted by the Council and the Parliament ECON Committee maintain the main elements of the Commission’s proposal. The Council’s regulation text does however specify that the qualitative version of the LCR shall apply according to national provisions until the introduction of a harmonised LCR in the EU.

4.1.3 Possibilities for Nordic coordination

The introduction of binding new liquidity and funding requirements at the EU/EEA level lies some years into the future, especially for the NSFR. For the LCR, Member States may impose an LCR version at the national level as they find appropriate until the Commission’s LCR is introduced (at the earliest) from 1 January 2015, as Sweden intends to do. The CRD IV texts now subject to trilogue negotiations do not appear to prevent the Nordic countries from coordinating their approach to the LCR/NSFR requirements, or even adopting common Nordic LCR/NSFR definitions and introduce these as binding requirements, until harmonised LCR/NSFR requirements are decided by the EU. A key concern may however be the limited availability of certain liquid assets in some countries, in particular Denmark and Norway. This issue may on the other hand be resolved by modifying existing definitions, e.g. in line with the options suggested by the Basel Committee, cf. above.

4.2 Capital requirements and capital buffers

4.2.1 The European Commission’s proposal

Definition of capital (own funds)

With an aim to ensure that only the highest quality capital instruments qualify as CET1, the regulation proposal lists 14 criteria that such capital instruments have to meet, cf. article 26 of the regulation proposal. These criteria imply a significantly stricter definition of capital than in the current CRD framework. Instruments no longer eligible as CET1 will be phased out of the regulatory capital over a 10-year period.

Minimum capital requirements

As mentioned above, the regulation proposal introduces a strengthening of minimum capital requirements, expressed as percentages of the total risk exposure of an institution (risk-weighted assets). Article 87 of the regulation proposal states that institutions at all times shall satisfy the following minimum requirements (Pillar I):

- CET1 capital ratio of 4.5per cent.
- Tier 1 capital ratio of 6.0 per cent.
- Total capital ratio of 8.0 per cent.

These new capital minima are to be introduced gradually over three years, reaching full effect on 1 January 2015, cf. Table 1 above. According to the Commission proposal, Member States can implement the new capital definitions and/or the new minimum requirements earlier than

the phase-in arrangements referred to in Table 1.[21] While the total capital requirement remains as today at 8 per cent, the tier 1 and CET1 capital requirements increase significantly (from 2 and 4 per cent, respectively).

The Basel I floor

As the Basel II framework was designed to be more risk sensitive than the Basel I rules, Basel II typically requires less regulatory capital than Basel I. The so-called Basel I floor means that a bank cannot have lower regulatory capital ratios than 80 per cent of the capital ratios that would have been required under Basel I rules. The Basel I floor was introduced as a temporary requirement for the transition from Basel I to Basel II, but has been reinstated into EU law until end-2011. The Commission's regulation proposal reinstates the floor again in 2013, to be applied until 2015, cf. article 476 of the regulation proposal.

Pillar II

The Pillar II supervisory review and evaluation process, where national supervisors can impose additional capital requirements (as well as carry out other measures) on individual or a group of institutions to address the specific risks institutions' face and pose, is retained in the Commission's proposal.

Leverage ratio

The Commission proposes to introduce a leverage ratio, which is defined as tier 1 capital divided by a measure of non-risk weighted assets, as a Pillar II supervisory tool. According to the proposal, the leverage ratio can be applied on individual banks at the discretion of supervisory authorities, cf. articles 85 and 416-417 of respectively the directive and regulation proposal. After a review and calibration period, the plan is to decide on whether to introduce the leverage ratio as a binding measure (Pillar I requirement) in 2018. Institutions will be required to disclose their leverage ratio from 2015 (Pillar III requirement), cf. articles 436 and 487 of the Commission's regulation proposal.

Capital buffers

The Commission's directive proposal includes two new capital buffer requirements; the capital conservation buffer and the counter-cyclical buffer, both of which have to be met with capital of the highest quality.

The *capital conservation buffer* shall according to the directive proposal consist of CET1 capital and amount to a minimum of 2.5 per cent of the total risk exposure of an institution (risk-weighted assets), cf. article 123 of the directive proposal. The buffer requirement is aimed at ensuring institutions' capacity to absorb losses in stressed periods, and to prevent erosion of the capital base when institutions experience problems.

The *counter-cyclical buffer* is intended to protect the banking sector and the real economy from systemic risk stemming from the boom-bust evolution in aggregate credit growth and more generally from any other structural variables and from the exposure of the banking

[21] In October 2011, it was agreed at the ministerial level in the EU that major European banks should enhance the quality and quantity of their capital, so that all major banks will have a common equity tier 1 (CET1) capital ratio of at least 9 per cent by 30 June 2012. The relationship between this *de facto* provisional requirement and the future CRD IV requirements has not been finally clarified.

sector to any other risk factors related to risks to financial stability. The counter-cyclical capital buffer requirement is set by national authorities for loans provided within their Member State. It shall according to the directive proposal consist of CET1 capital and be set between 0 and 2.5 per cent of the total risk exposure of an institution (risk-weighted assets), cf. article 124 of the directive proposal. A designated authority shall be responsible for setting the counter-cyclical buffer rate on a quarterly basis (typically with a 12-month deadline for application), in accordance with a so-called buffer guide, cf. article 126 of the directive proposal. The buffer guide is meant to ensure that a counter-cyclical buffer is required during periods of excessive credit growth and released in a downturn.

So long as the counter-cyclical buffer is set at, or below, 2.5 per cent, Member States have to mutually recognise and apply the capital charge to institutions in their Member State (reciprocity). National authorities can set the buffer target higher than 2.5 per cent. For the parts of the buffer target exceeding 2.5 per cent, authorities can *choose* to recognise and apply the full capital charge to institutions in their Member State, or to leave it at 2.5 per cent, cf. article 127 of the directive proposal.

If institutions fall below the two buffer targets they will face constraints on the distributions of earnings, and possibly other sanctions, until the buffer targets are reached, and they will have to submit a capital conservation plan to their supervisory authority, cf. articles 131 and 132 of the directive proposal.

The buffer requirements are to be introduced gradually from 1 January 2016, reaching full effect on 1 January 2019, cf. Table 1 above and article 149 in the directive proposal. According to the Commission's proposal, Member States may introduce the new counter-cyclical buffer earlier than the phase-in arrangements tabulated in Table 1 require if doing so is justified by excessive credit growth. If a Member State introduces the counter-cyclical buffer earlier than the proposed phase-in arrangements require, other Member States will not have to recognise the capital charge to institutions in their Member State.

4.2.2 Council and Parliament ECON Committee texts

In general

The CRD IV texts adopted by the Council and the Parliament ECON Committee maintain the main elements of the Commission's proposal, with a few changes and additions. As described in Chapter 3, *the Council's changes* include, *inter alia*, more flexibility at the national level to implement measures to address systemic risk. The Council's and the ECON Committee's text provides the opportunity for Member States to impose stricter prudential requirements for domestically authorised institutions, i.e. requirements on level of own funds, requirements for large exposures, public disclosure requirements, the level of the capital conservation buffer, liquidity requirements and risk weights for targeting asset bubbles in residential and commercial property. Such a decision by a national authority could according to the Council's text only be overruled if, following a negative opinion by the EBA, the European Systemic Risk Board (ESRB) or the Commission, the Council votes by qualified majority against the measures. Member States would be able to increase risk weights for residential and commercial property and intra financial sector exposures beyond those provided in the CRD IV regulation and up to 25 per cent.

Two versions of a systemic (risk) buffer
A new element in the Council and Parliament ECON Committee texts is an option for national authorities to introduce a capital buffer requirement for systemic risk. *The Council's systemic risk buffer requirement* is aimed at preventing and mitigating long-term non-cyclical systemic or macro-prudential risk, cf. articles 124a and 124b of the Council's directive text. Member States may recognise systemic risk buffer requirements set by other Member States, for branches located in the Member State setting the buffer requirement (voluntary reciprocity). As for the other two buffer requirements, institutions will face constraints on the distributions of earnings, and possibly other sanctions, if they fall below the systemic risk buffer target. The systemic risk buffer requirement shall according to the Council's text consist of CET1 capital, and is expressed as a percentage of the exposures in the Member State (risk-weighted assets). The systemic risk buffer requirement may apply to exposures located in the Member State that sets the buffer, other Member States and third countries. The buffer requirement may apply for all exposures so long as it is set to 3 per cent or below, and for domestic and third country exposures if it is set to 5 per cent or below, without having to seek prior Commission approval. Member States could impose even higher buffers with prior Commission authorisation in the form of a delegated act. If a Member State decides to impose a systemic risk buffer of up to 3 per cent for all exposures, the buffer has to be set equally on all exposures located within the EU.

The Parliament ECON Committee's systemic buffer requirement is intended to be imposed on institutions according to their systemic relevance for the European or an individual domestic financial market, cf. articles 132a and 132b of the Committee's directive text. The buffer requirement shall according to the Parliament's text increase with the individual institution's systemic relevance, expressed as CET1 capital in per cent of the institution's exposures (risk-weighted assets). Member States may require the most systemic relevant institutions to maintain such a systemic buffer of up to 10 per cent if this is justified by exceptional circumstances such as the size of the banking group in relation to the economy of the home country or the degree of concentration in the domestic financial market. The Committee's text implies that the systemic buffer of banking groups which are identified as systemically important on a global or European level shall be maintained at consolidated or subconsolidated level within the EEA even if subsidiaries of that group have been identified as systemically relevant on the domestic level in one or several Member States. The systemic buffer for entities which are systemically relevant in only one Member State shall be maintained on single entity or subconsolidated level within that Member State.

4.2.3 Possibilities for Nordic coordination

The strengthening of minimum tier 1 and CET1 capital requirements within the CRD IV does not appear to pose challenges for Nordic credit institutions as a whole. Most institutions also already meet a leverage ratio requirement of 3 per cent tier 1 capital.

Norway, Iceland and Sweden are all considering implementing stricter capital requirements than those in the CRD IV proposal, as well as earlier implementation than the proposed CRD IV timeframe; cf. Section 3.3.2 in Chapter 3. These countries may also consider early introduction of a leverage ratio disclosure requirement, but will probably await the Commission's review and calibration period before deciding on any binding measure. Finland and Denmark plans to implement the new capital requirements in line with the CRD IV proposal's levels and timeline.

The CRD IV texts now subject to trilogue negotiations generally include harmonised prudential requirements, but the texts also allow Member States to impose stricter prudential requirements, including higher capital requirements and buffer requirements, than the forthcoming EU/EEA minima, under certain circumstances. The forthcoming CRD IV framework does not appear to prevent the Nordic countries from establishing cooperation on such prudential requirements or to otherwise adopt a coordinated approach. The Nordic countries could for instance establish a system of mutual recognition of capital requirements and buffer requirements for exposures incurred in the country setting the requirement (reciprocity). Such a system could imply that if a Nordic country were to implement stricter capital requirements to, say, prevent and mitigate systemic risk in that country, the other Nordic countries would accept that these requirements were to apply for all relevant exposures incurred in that country by all Nordic institutions operating there. As discussed in section 3.2.3 in Chapter 3, such reciprocity may allow individual countries the flexibility to set stricter prudential requirements for domestic exposures in accordance with specific national circumstances, without conflicting with the "level playing fields."

Moreover, it is the working group's view that market participants in any event will put great emphasis on the extent to which financial institutions meet the forthcoming EU requirements as soon as the requirements' design is finalised. This will not least include the leverage ratio, which may be established as a tool for comparison and evaluation of institutions' solvency.

4.3 Risk weights in internal risk models

4.3.1 Background

How banks and other financial institutions calculate their total risk exposure (risk-weighted assets), i.e. the denominator in the capital requirements ratios, is of great importance for the actual capital requirements and adequacy ratios. When institutions calculate their total risk exposure for regulatory capital purposes, they can apply the standardised approach or the internal ratings based (IRB) approach. Institutions that do not have permission for the use of the IRB approach shall use the standardised approach. Generally, regulatory risk weights on residential mortgage loans are low, due to historically low losses on such loans.

Basel II resulted in a decline in residential mortgage loan risk weights

The introduction of Basel II had significant impact on residential mortgage (RM) risk weights, and in particular for IRB banks in the Nordic countries. For Nordic IRB banks, the risk weight for secured RM loans declined from 50 per cent (Basel I) to a range between 6 to 18 per cent. The risk weights tend to be lower in the Nordic area than elsewhere in Europe, as illustrated in Chart 4.1. Most likely this is due to a historic record of relatively low default rates (also when including the years around the Nordic banking crises in the 1980s and 1990s), combined with the fact that the current economic climate is relatively benign in the Nordic area compared with the rest of Europe. Structural differences such as the social safety net associated with the Nordic welfare state may also be part of the explanation.

Chart 4.2 shows the effect of risk-weighting on banks' tier 1 capital ratios, which are generally much higher than the non-weighted equity ratios (where total assets rather than risk-weighted assets constitute the denominator).

Different IRB models, different supervisory practises and different legal interpretations may also lead to differences in risk weights for fairly similar exposures. Because the denominator

in the capital requirements ratios is of great importance for the actual capital requirements and adequacy ratios, such differences can make it difficult to compare solidity across borders and across institutions.

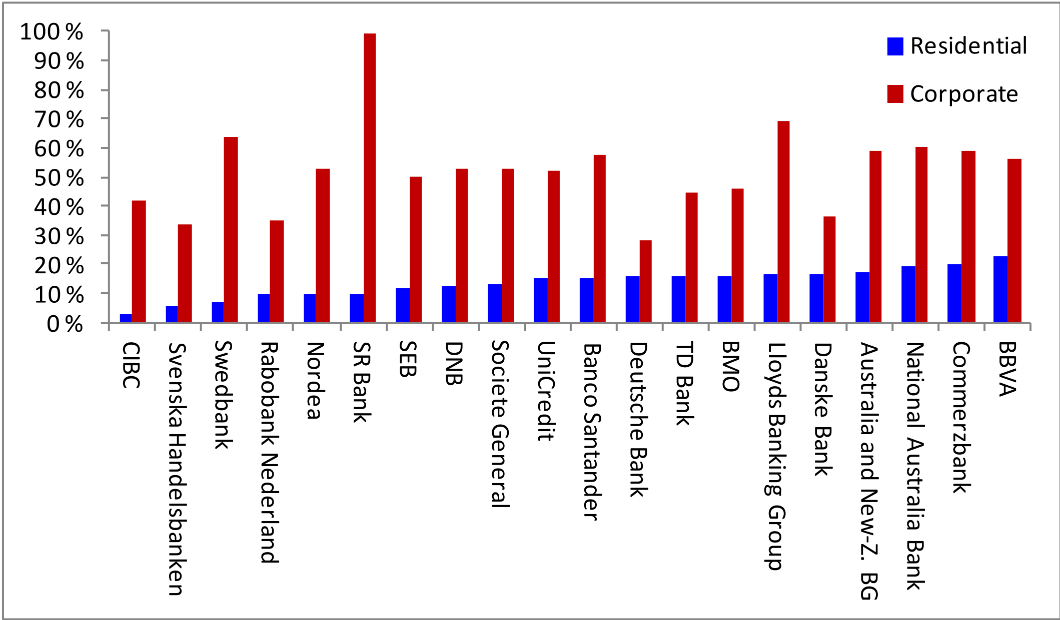

Chart 4.1. Average IRB risk weights for residential mortgage loans and corporate loans. Sample of banks. Per yearend 2011.
Source: Finanstilsynet (Norwegian FSA)

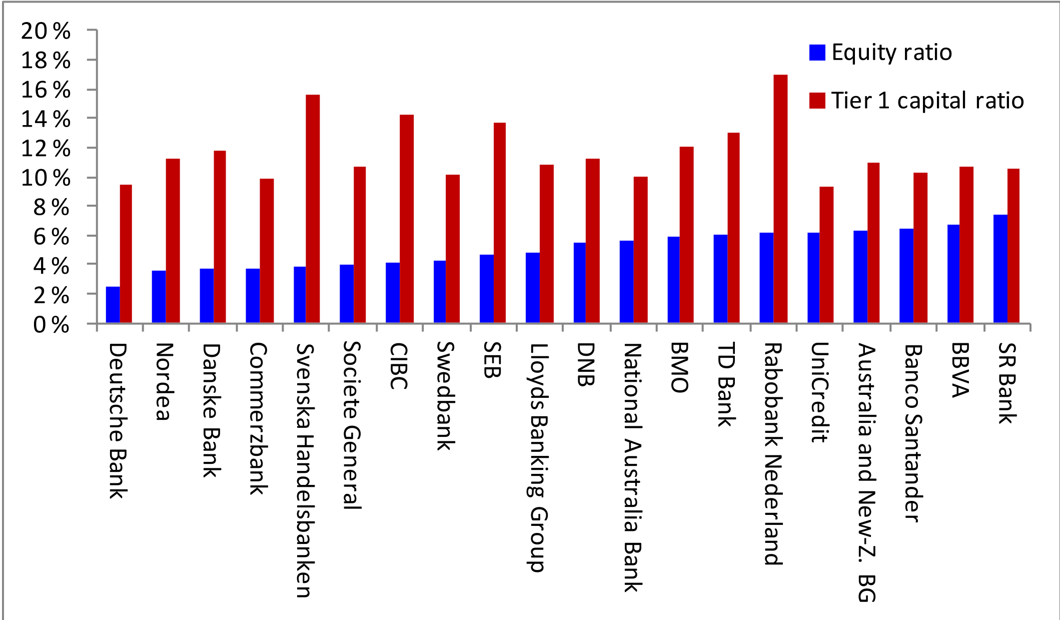

Chart 4.2. Tier 1 capital ratios and equity ratios. Sample of banks. Per yearend 2011.
Source: Finanstilsynet (Norwegian FSA)

Do the models measure risk appropriately?
In the recent years, the development in RM credit risk has diverged somewhat among the Nordic countries, with falling housing prices and rising household sector loan losses in Denmark, while the other countries have experienced stable or rising property prices and limited loan losses. IRB models seem to have reflected this in some sense, resulting in slightly

higher risk weights in Denmark than for example in Sweden and Norway. However, there may still be reason to question the ability of internal models to measure latent risk building up over time. The developments in housing prices and household debt are highlighted as a major concern for financial stability in the Nordic area, both by domestic authorities and international observers like the OECD and the IMF. However, the Nordic area IRB RM risk weights tend to reflect that measured risk is rather low, and with little tendency to rise along with the growing macro-prudential concerns. Although the financial stability concerns to some extent relate to the contagious effects of a consolidating household sector, rather than its direct loss potential, there may be reason to worry that the risk of higher household debt burden is not fully reflected in IRB assessments.

There are several potential explanations for the discrepancy between the perceived risk at the macro-prudential level and IRB assessments. Firstly, the internal models are estimated on recent historical data, which includes a prolonged period of low RM default rates and low interest rate levels. In periods of low interest rates, the debt burden is easier to carry, which will be reflected in estimated models. In the Nordic area, supervisors have required the calibration of internal models to be adjusted for the effects of a non-representative estimation period. However, the marginal effect of loan-to–income ratios on the likelihood of default may still be under-estimated. Also, it seems to be the case that credit and loss cycles for RMs span out over longer time periods than for e.g. corporate lending. Thus it can be argued that RM models need to be based on data covering particular long time periods for the models to be adequate, and thus data limitations may be a more critical issue for RM models than is the case for other segments.

Secondly, the macro-prudential concerns related to the residential mortgage market are partly driven by concerns about the sustainability of current housing price levels, and the potential effects of a significant downward price correction. Inflated housing prices may actually work the opposite way for internal model assessments, as financial information is influenced by market prices, e.g. through the loan-to-value (LTV) ratio. Rising house prices are therefore likely to cause internal models to measure the risk as declining.

Are RM IRB models used as intended?

A core principle for the Basel II internal model regime is its broad application in each institution. An IRB institution is required to use the IRB models risk assessments in credit granting, risk pricing, management and control. The aim is to achieve consistency and better risk management. However, when observing the market for RMs there seems to be less price differentiation than what is the case for other segments. Possible explanations may be that operating differentiated pricing is too costly, that the price competition is tighter in the RM segment, or that institutions take model-based risk assessments less serious than for other segments (e.g. because the perceived risk is low).

4.3.2 Current regulations

Point 15 in the preamble of the current directive 2006/48/EC (colloquially referred to as the Capital Requirements Directive, or CRD, together with directive 2006/49/EC) states that Member States may establish stricter rules than those laid down in certain parts of the regulative, specifically including article 75. Article 75 states that the capital requirement for credit risk is 8 percent of risk weighted assets when calculated in accordance with the directive’s Section 3. The directive is not specific about how stricter rules than Article 75 can be applied. However, any rule that either increase the 8 percent charge, or serves to increase

the calculated risk weighted assets, will implicate an increased level of the minimum capital required. In what follows we briefly describe the current requirements for calculation of risk-weighted assets under the standardised and IRB approach.

The standardised approach[22]

Institutions that do not have permission for the use of the IRB approach shall use the standardised approach. Credit risk is segmented into 16 exposure classes (Article 79), of which class (h) “claims or contingent retail claims” and (i) “claims or contingent claims secured on real estate property” are the most relevant for residential mortgage (RM) exposures. For RMs that are “fully and completely secured, to the satisfaction of competent authorities” the exposure class (i) can be applied, implying a risk weight of 35 per cent (Annex IV, point 45). The RM exposures that do not qualify in this respect are to be classified according to (h) if certain requirements are met, implying a risk weight of 75 per cent, and in the residual exposure class (p) if the requirements are not met, implying a risk weight of 100 per cent. The requirements for retail classification (h) are given in Article 79(2).

As reviewed above, under current regulations there is considerable discretion for Member States to apply stricter rules than the minimum standards in the directive, and for Article 75 in particular. However, according to a survey by CEBS/EBA it does not appear to be the case that this discretion is actually used to any extent, at least not for the specific purpose of increasing the level of standard method RM risk weights.[23] Most likely this is due to the flexibility in the aforementioned point 45 of annex IV being sufficiently flexible, e.g. allowing for the LTV ratio to be specified autonomously.

Under the standard method, a Member state imposing stricter rules, as a national choice or by exercising the general discretion to apply stricter rules under Article 75, may enforce these rules on a domestic bank being a subsidiary of a foreign bank. However, there is no obliged reciprocity, meaning that a host Member state cannot necessarily enforce stricter rules on branches of foreign banks operating in their jurisdiction.

A possible tightening of the standard approach requirements for RM could involve i) increasing the 35 per cent charge for secured RM, and ii) lowering the LTV threshold for the secured RM exposure class.

The IRB approach

Competent authorities may permit credit institutions to calculate their risk weighted exposure amounts using the IRB approach. According to Article 129, in the case of application for permission submitted by an EU parent credit institution for a subsidiary credit institution in another Member state, the application shall be submitted only to the competent authority responsible for the consolidated supervision of the EU parent credit institution (the consolidating supervisor). The competent authorities shall work together in full consolidation to decide whether permission can be granted, and under which terms and conditions.[24] The IRB assessment and follow-up process is organised in colleges chaired by the consolidating

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[22] All references to articles, annexes etc. are henceforth made to directive 2006/48/EC, unless otherwise stated.

[23] See http://www.eba.europa.eu/documents/Publications/Other-Publications/Comment-letters-by-CEBS/Comments-on-the-Single-Rule-Book/CEBS-response-SRB.aspx

[24] In absence of a joint decision, the home supervisor may make its own decision on the application.

supervisor. For case of branches of an EU credit institution situated in another Member state, the application process and IRB follow-up is the sole responsibility of the home supervisor.

Without prejudice to a specified set of exceptions, credit institutions with permission to apply IRB shall implement IRB for all exposures (Article 85). Credit institutions with permission to apply IRB shall not revert to the standard method except for demonstrated good cause and subject to the approval of the competent authorities (Article 85).

In the IRB approach, credit risk is segmented into seven exposure classes (Article 86), of which class (d) “retail claims or contingent retail claims” include RM exposures. Under the IRB approach credit institutions generally provide own estimates for the probability of default (PD). For the retail exposure class (d) specifically, own estimates for loss given default (LGD) and conversion factors (KF) are also required, whereas this regards only advanced IRB permits (AIRB) for e.g. corporate exposures.

Given these parameters, retail exposures are weighted using the *risk weight formula* specified in Annex VII part 1-3. The resulting risk weight is a measure for the amount of capital needed, per unit lent, sufficient to cover the loan losses in a stressed economic scenario that is in excess of average losses under more normal economic conditions. For a given set of IRB parameters (PD, LGD, and KF) the risk weight will depend on the sensitivity of the risk of the exposure to economic cycles (correlation parameter). The higher the correlation parameter, the higher the risk weight will be. The correlation parameter is specified to 15 per cent for RMs in the directive (part 1, paragraph 12).

Several legislative options may be available for RM under the IRB approach, such as i) measures that will act to increase the average level of RM IRB risk weights, ii) measures that may enhance the models’ ability to reflect a build-up of latent risk, and iii) the possibility of replacing RM IRB risk weights with a template charge.

According to the aforementioned survey by CEBS/EBA, no Member state has exercised the discretion to apply stricter rules than the minimum standards in Article 75 in order to increase the level of RM risk weights for the IRB approach. However, differences in the practice of applying the transitional floors may qualify in this regard (chapter 1, article 152).

In contrast to what is the case for the standard method, a Member state imposing stricter rules for the IRB approach for domestic banks cannot enforce these rules on a domestic bank being a subsidiary of a foreign bank if these rules have implications for the structure or the calibration of the internal models. Issues regarding the internal model need to be coordinated with the college of competent authorities, chaired by the consolidating supervisor. As it is often the case that the IRB systems of the parent bank and its subsidiaries are interrelated, there may be obstacles to imposing stricter requirements unilaterally. However, stricter rules that do not affect the internal model itself, but rather the way it is used in capital adequacy reporting, would be binding also for the subsidiary (a requirement to apply a higher correlation parameter than the directive minimum requirement for RM exposures in the risk weight formula may serve as a relevant example).

As was the case of the standard method, a host Member state cannot enforce stricter rules with implications for the IRB models in branches of foreign banks in their jurisdiction. If regulation efficiency is to be ensured, tightening of IRB minimum standards therefore needs to involve coordinated legislative action across jurisdictions.

4.3.3 The European Commission's proposal

One of the intentions of the European Commission's proposal for CRD IV is much greater harmonisation of requirements and thus less scope for national discretion. This section provides an overview of the rules of particular importance for the risk weights RM exposures. The discussion in this paper is based on the proposal from the European Commission.
In point 9 of the preamble the following is said about the discretion for setting stricter requirements for RM risk weights:

> "*With regard to the peculiarity of immovable property markets which are characterized by economic developments and jurisdictional differences that are specific to Member States, regions or local areas, competent authorities should be allowed to set higher risk weights or to apply stricter criteria based on default experience and expected market developments to exposures secured by mortgages on immovable property in specific areas*"

Although these arguments are rather general, the discretion seems only to apply for risk weights under the standardised approach.

Standardised approach

The proposed directive does not suggest revising the standardised approach risk weight of 35 per cent for secured RM exposures. However, competent authorities shall at least annually evaluate whether the 35 percent charge is suitable given the recent default history and an assessment of future market conditions (Article 119 paragraph 2). Based on this assessment, and on financial stability concerns, national regulators may impose higher risk weights or more stringent conditions than those stated in Article 120 paragraph 2 and Article 121 paragraph 2, after having consulted the issue with the European Banking Authority (EBA).

The proposed directive takes a new direction on the issue of reciprocity under the standardised approach. A foreign financial institution with operations in a Member state (e.g. branch) that uses the standardised approach for RM exposures is to be affected by the host authorities decisions concerning the risk weights and general criteria for exposures in their jurisdiction (Article 119 paragraph 3).

IRB approach

Even though the arguments made in the Commission's proposed preamble (citation above) could apply to RMs independently of whether they are classified under the standard or IRB approach, the proposed regulation does not seem to open for the same type of national discretion under the IRB approach.

4.3.4 Council and Parliament ECON Committee texts

The adopted Council presidency proposal of 15 May 2012 elaborates and clarifies on the Commission's CRR proposal, Article 119-121, 160, and 443 and the CRD proposal Article 98. The result is less difference between the standardised and IRB approach concerning the possibility to apply stricter rules due to prudential concerns.

The technical standards to be developed by EBA, for conditions where stricter rules or higher risk weights under the standardised approach may be applied, shall include a clarification of the term "financial stability considerations" (CRR, Article 119-121).

Concerning the LGD floor (CRR, Article 160), the compromise proposal opens for the application of a stricter floor than the minimum, if the process for application of stricter rules under the standardised approach (CRR, Article 119-121) is followed. This gives room for national discretion and contributes to less difference in the treatment of the IRB and standardised approach.

Moreover, reciprocity is now introduced also under the IRB approach, as any Member State's decision to apply a stricter LGD floor will apply for all exposures located in the Member State. This stands in contrast to the Commission's proposal, where reciprocity is confined to decisions under the standardised approach.

CRR Article 443a explicitly concerns macro-prudential or systemic risk identified at the level of a Member State. If a Member State identifies "changes in the intensity" in the risk of disruption in the financial system, and consider that it would be better addressed by means of national measures, it shall notify the Commission, the Council, ESRB, and EBA of that fact and submit relevant evidence.

CRR Article 443b concerns the empowerment of the Commission with delegated acts as described in the Commission's proposal Article 443a. However, the delegated acts now regard the power to impose stricter rules, for a period of one year, in order to address changes in micro- and macro-prudential risk which arise from the market developments in at least three Member States or outside the union affecting at least three Member States.

CRD Article 98 concerns powers to impose higher multiplication factors, or higher capital add-ons or taking other appropriate effective measures if material deficiencies are identified in risk capture by an institutions internal approach.

4.3.5 Other ongoing work

Nordic work

The Nordic Capital Adequacy Working Group (NCAWG) has provided reports on the impact of IRB on capital requirements in financial institutions in the Nordic region to "Nordisk Banktilsynsmøte" each year since 2008. The report has consistently found significant differences between the Nordic countries, especially regarding corporate PDs and risk weights. The meeting on 3 December 2010 elected to appoint a new working group with the aim of providing an in debt analysis of the driving factors behind these differences.

The Nordic working group for IRB comparisons (NWGIC) started its work at 14 June 2011. NWGIC will analyse, theoretically and empirically, the driving factors of IRB risk weight differentials between banks operating in the Nordic area, with a particular view on evaluating the extent to which these differences are due to differences in supervisory practice between the Nordic supervisory authorities. The group will aim to submit its first report by July 2012. The overall aim for the report is to improve the information basis that may facilitate fruitful discussions on calibration issues, harmonization and supervisory practice at Nordisk Banktilsynsmøte.

EBA and the Basel committee
EBA and the Basel committee have launched similar projects which aim to understand the differences in the risk weights coming out of banks in member countries' internal models. Projects include analysis of risk weight differentials, assessment of the range of supervisory practices, and an evaluation of the sufficiency of the information in pillar 3 reporting.

Sweden
The Swedish FSA *Finansinspektionen* is presently running a project which analyses risk weights on residential mortgages. The background is an acknowledgement that Swedish risk weights on such exposures are very low in an international perspective, and the work currently being conducted by the Basel committee on the same issue. *Finansinspektionens* project also addresses what changes would be possible to implement in order to increase risk weights. The agency is analysing three different ways within the IRB approach:

- Introduction of floor risk weight, whether for an individual exposure and for a portfolio
- Adjusting the correlation factor in the risk weight calculation
- Adjusting the calibration factor in the risk weight calculation

An alternative option is to raise the floors of the banks' input variables in the risk weight function, i.e. the probability of default (PD) and loss given default (LGD). These variables are not set by the Basel rules, but are determined by the regulatory authority (unlike the correlation factor and calibration factor).

Norway
Norwegian authorities are concerned about the increasing reliance on IRB models for the calculation of capital requirements for mortgage loan exposures. The historical data used in models may not be suitable proxies for future risk, as they do not account for changes in fundamental risk factors, such as increased indebtedness in the household sector. The problem with high household dept is that this may enhance an economic downturn. For Norway, it is important to look into how this issue can be addressed. An effective measure already in place is of course the Basel I floor, which in Norway will be enforced until further notice.

Moreover, Finanstilsynet (the Norwegian FSA) is running a project to analyse risk weights on residential mortgages in Norway. The aim of the project is to assess the extent to which risk weight differentials are due to differences in internal models or differences in portfolio risk, and to evaluate whether the models are adequately calibrated to assess the loss potential for residential mortgages.

Several options may be available to national authorities wishing to increase risk weights on residential mortgage loan exposures. Norwegian authorities aim to look into some of these, e.g.:

- For the IRB approach: Risk weight multiplier, whereby the IRB-produced risk weight is multiplied by a given factor.
- For the IRB approach: Parameter floors in the risk weight formula (if, say, the PD and/or the LGD are increased, the risk weight will increase).
- For both the standardised and the IRB approach: A general risk weight floor, set equal to or above the standardised approach risk weight.

4.3.6 The possibility for a Nordic approach to risk mortgage loan risk weights

The current rules on residential mortgage loan risk weights leaves room for imposing stricter rules at the national level than the EU minima. This opportunity seems to be retained, although somewhat reduced, in the forthcoming CRD IV framework. The CRD IV texts now subject to trilogue negotiations allow Member States to impose stricter prudential requirements, including stricter rules or approaches to residential mortgage loan risk weights, in certain areas or under certain circumstances. Hence, the CRD IV framework does not appear to prevent the Nordic countries from establishing cooperation on such prudential requirements or to otherwise adopt a coordinated approach.

As partly discussed above, several options may be available to national authorities wishing to increase risk weights on residential mortgage loan exposures. The working group has not undertaken a thorough evaluation of these options, but we do note that some of the options appear feasible at the national and Nordic level. In this regard, reference is made to other ongoing work in this area. We will however make the key observation that the "risk weight multiplier" option may have potential for increased IRB approach risk weights while at the same time retaining the important risk differentiation features of the IRB approach.

The working group notes that the forthcoming CRD IV framework does not appear to prevent the Nordic countries from establishing a system of mutual recognition (reciprocity) of national risk weight considerations, with regard to both the IRB and the standardised approach. For IRB institutions, such reciprocity can be effectuated in the supervisory colleges and in meetings between Nordic supervisors. The working group notes that the Council and the Parliament ECON Committee have introduced more reciprocity also for the IRB approach, which means that decisions made by host country supervisory authorities on risk-weighting of real estate exposures will also apply for subsidiaries and branches operating in the host country.

5 The working group's views and conclusions

5.1 Introduction

In this chapter, the working group summarises and concludes on the main topics discussed in the two preceding chapters. Our principal conclusion is that Nordic coordination on new liquidity, funding and capital requirements – as well as on residential mortgage loan risk weights – may be possible and desirable. The working group concludes that it is legally possible to introduce a system of mutual recognition of prudential requirements for exposures incurred in the country setting the requirements (reciprocity). Such a system may have the potential to ensure "level playing fields" across countries, whilst at the same time enabling each individual country to address their specific concerns and challenges.

However, we do note, as we did in Chapter 3, that the Nordic countries already cooperate on financial regulation and supervision. We also note that the role and powers of the financial supervisory authorities differ somewhat between the Nordic countries. Some authorities are for instance more independent of the responsible ministry than others. This will delimit the potential for cooperation and coordination at the ministerial level, and in certain areas necessitate closer cooperation and coordination between supervisory authorities. Moreover, this is also true for the fact that the Nordic supervisory authorities have different ways of practising Pillar II measures under the existing capital adequacy framework.

5.2 Liquidity and funding: Common definitions

The working group takes the view that the introduction of new liquidity and funding requirements are crucially necessary to improve the resilience of both Nordic and European credit institutions against disruptions in funding markets. It is in this context very important that there are established appropriate and unambiguous definitions of the requirements, to ensure consistent application and cross-border transparency. As discussed above, this lies some years into the future, especially for the NSFR.

The CRD IV texts now subject to trilogue negotiations do not appear to prevent the Nordic countries from coordinating their approach to the LCR/NSFR requirements, or even adopting common Nordic LCR/NSFR definitions and introduce these as binding requirements, until harmonised LCR/NSFR requirements are decided by the EU. Among the Nordic countries, Iceland and Sweden plan to implement an LCR before a common European definition is established, while Norway will assess the possibilities for early implementation. Denmark does not plan to accelerate the application of any of the new prudential requirements beyond the proposed phase-in arrangements.

While there are good reasons to await further concretising at the EU level and in the Basel Committee, there are also arguments in favour of seeking out a coordinated Nordic approach now. In the working group's view, a common Nordic LCR definition – and perhaps also a common NSFR definition – could be useful until harmonised LCR/NSFR requirements are decided by the EU and entered into force, and should be analysed further. However, Sweden plans to introduce a Swedish version of the LCR from 1 January 2013 as mentioned in Chapter 3.3.2. Common definitions could have a disciplining effect across the Nordic region, even if the individual Nordic country only were to apply the definitions as supervisory tools and reporting standards. Common definitions could in addition ease comparison and improve transparency between institutions domiciled in different Nordic countries.

If the Nordic countries were to establish a common LCR definition, this should in the working group's view build on the definition outlined in the Basel III standards as well as the requirements set out in the CRD IV regulation proposals, and fully take into account the Basel Committee's suggested options for jurisdictions with insufficient supply of liquid assets.

If a common LCR definition were to be pursued, the working group envisages that the Nordic supervisory authorities may be asked to analyse the possibility for a joint LCR definition. Following the supervisory authorities' analysis of the possibility and potential for a common definition, the relevant national authority could decide whether to go forward with the definition as a binding requirement, a reporting standard or guidance.

A potential common Nordic LCR definition could also form a basis for a coordinated Nordic approach with regard to influencing the efforts by the EBA and the European Commission to develop a common European LCR.

5.3 Capital: Level playing fields through reciprocity

The CRD IV framework will probably include some flexibility at the national level, whereby national authorities may impose stricter requirements than the forthcoming EU minima, and/or introduce new (and possibly stricter) requirements earlier than the proposed CRD IV timeframe. The CRD IV framework therefore does not appear to prevent the Nordic countries from establishing cooperation on prudential requirements or to otherwise adopt a coordinated approach. The Nordic countries could for instance establish a system of mutual recognition of capital requirements and buffer requirements for exposures incurred in the country setting the requirement (reciprocity). Such a system could imply that if a Nordic country were to implement stricter capital requirements to, say, prevent and mitigate systemic risk in that country, the other Nordic countries would accept that these requirements were to apply for all relevant exposures incurred in that country by all Nordic institutions operating there.

As we mentioned in Chapter 3, reciprocity may allow individual countries the flexibility to set stricter prudential requirements for domestic exposures in accordance with specific national circumstances, without conflicting with the "level playing fields." There would, for example, be little room for regulatory arbitrage, as requirements would follow exposures. It should in any event be a goal to ensure that all financial institutions operating in a Nordic country can compete on equal terms in that national market, regardless of whether the institutions are domiciled in that national market or elsewhere in the Nordic region. This is experimentally illustrated in Chart 5.1 below, where two incarnations of capital requirements reciprocity are sketched, as well as the case of no reciprocity coupled with national flexibilities. The second figure in Chart 5.1 illustrates a situation with full national flexibility (within the EU framework, of course) on domestic institutions, as well as on exposures incurred in that country by other institutions within the reciprocity area.

While complying with different requirements in different countries could imply higher administrative costs for cross-border financial groups, this may be curtailed if the variation in requirements is limited to harmonised policy tools and definitions, e.g. so that only rates differ across countries. In the working group's view, this should be a prerequisite for any reciprocity system. If a group of countries were to establish such a reciprocity system, efficiency considerations may imply that the system should be as broad as possible, covering the sum of stricter capital (own funds) requirements as such, leverage ratio requirements, the counter-

cyclical buffer (in excess of the compulsory reciprocity up to 2.5 per cent), the capital conservation buffer and the systemic risk buffer.

The working group assumes that a possible reciprocity system would not prompt changes in supervisory responsibilities, so that it would still be the home supervisor who has the main supervisory responsibility for branches operating in other countries. We also assume, however, that if the Nordic countries were to establish a reciprocity system, this would give rise to more cooperation and coordination between Nordic supervisors both generally and within supervisory colleges, e.g. when it comes to exchanging information on various national requirements rates, etc. In general, the working group emphasises the importance of well-functioning supervisory colleges.

Opting for the establishment of a broad, Nordic reciprocity system on capital requirements may be one way for the Nordic countries to avoid a potential call for a “race to the bottom” with regard to prudential requirements, by safeguarding the stability and competitiveness of each country’s financial sector in accordance with national considerations and preferences. Such a system would of course not prevent any Nordic country from implementing the baseline CRD IV framework if it so desires, but it would prevent such a country’s financial institutions from operating on laxer terms in other Nordic countries which choose to have stricter requirements. However, the working group notes that some countries in the EU still fears for a “race to the top”, and that too high capital requirements may trigger deleveraging and a “credit crunch.”

The working group envisages that the Nordic supervisory authorities may be asked to look further into the possibility of establishing a Nordic reciprocity system on capital requirements, including an impact study and a mapping of the specific legislative measures necessary to establish such a system.

5.4 Residential mortgage exposures: Risk weight reciprocity

Both the current and the forthcoming EU rules on residential mortgage loan risk weights leave room for imposing stricter rules at the national level, and several options may be available to national authorities wishing to increase risk weights. As discussed in section 4.3 in Chapter 4, it will probably be possible for Member States within the forthcoming CRD IV framework to impose stricter prudential requirements, including stricter rules or approaches to residential mortgage loan risk weights.

On a Nordic level, a joint or coordinated approach can be achieved in cross-border supervisory colleges and in meetings between Nordic supervisors, where the supervisors in principle can effectuate measures to increase these risk weights. Moreover, an intention to achieve a joint or coordinated approach may be included in a broad Nordic reciprocity system; cf. above. This is a natural inclusion in such a system, as the way credit institutions calculate their total risk exposure (risk-weighted assets), i.e. the denominator in the capital adequacy ratios, are of great importance for actual capital requirements and levels. In this context, reciprocity would refer to a mechanism in which the host country’s rules on the calculation of residential mortgage exposure risk weights will apply for exposures incurred in the host country setting the requirement, regardless of whether the exposures are incurred by institutions domiciled there, by subsidiaries of foreign institutions domiciled within the reciprocity area, or by branches of foreign institutions domiciled within the reciprocity area.

The difficulty of comparing capital adequacy ratios between institutions domiciled in different countries, poses challenges for both supervisory authorities and the institutions themselves. The institutions can contribute to more transparency and better comparability by providing better information about how they calculate their capital requirements and capital adequacy ratios. Institutions are for instance free to publish hypothetical capital adequacy ratios based on different calculation methods. The working group also calls on the Nordic supervisory authorities to contribute to more transparency and better comparability.

As mentioned in Chapter 4, the working group notes that the Council and the Parliament ECON Committee have introduced more reciprocity also for the IRB approach, which means that decisions made by host country supervisory authorities on risk-weighting of real estate exposures will also apply for subsidiaries and branches operating in the host country. The forthcoming CRD IV framework does not appear to prevent the Nordic countries from establishing a system of mutual recognition (reciprocity) of national risk weight considerations, with regard to both the IRB and the standardised approach. For IRB institutions, such reciprocity can be effectuated in the supervisory colleges and in meetings between Nordic supervisors.

In the working group's view, a joint or coordinated approach to IRB calibration and minimum requirements on residential mortgage exposure risk weights, could contribute to "level playing fields" in the Nordic countries, as well as to easier comparison of capital adequacy ratios between institutions domiciled in different countries.

5.5 A note on branches of foreign institutions

The working group notes that there are particular challenges for host country supervisors concerning the operations of branches of foreign institutions. Potential conflicts between the home and host supervisor may create competitive distortions, and in the extreme even jeopardise financial stability in the host country. The working group is of the view that the Nordic supervisory authorities should aim to strengthen their cooperation and coordination when it comes to the supervision of branches in general, host country decisions, IRB calibrations and risk weights issues, in order to promote the alignment of financial stability considerations, as well as further integration of Nordic financial markets.

5.6 Follow-up: Supplementary working group report

The working group has prepared this report in parallel to the CRD IV discussions in the Council and the Parliament, and has naturally not been able to build its considerations on a finalised EU framework. Although the working group has reached consensus on several important issues, it may be desirable for the group to meet again later in 2012, after the EU has adopted the directive and the regulation constituting the CRD IV package, to discuss further cooperation between the Nordic countries.

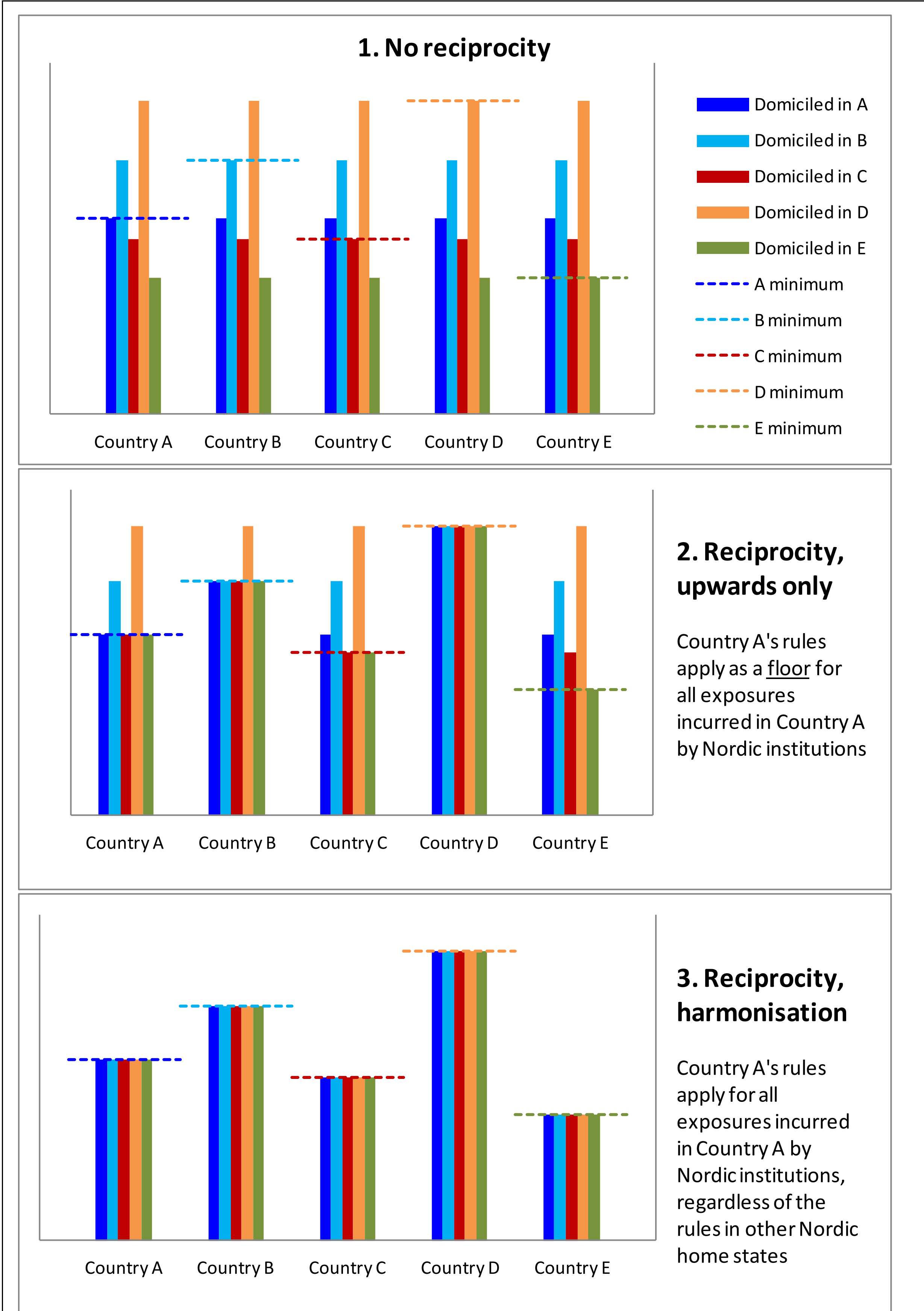

Chart 5.1. Reciprocity illustrated.

Annex 1: Further on legal processes in the Nordic countries

Denmark

The financial sector in Denmark is regulated by a number of laws and administrative regulations (*bekendtgørelser*). Credit institutions (banks, savings and mortgage banks) are regulated by the Financial Business Act (*lov om finansiel virksomhed*), which also regulates investment companies, investment management firms and insurance companies. Parts of the Act also apply to savings undertakings, investment advisers, rating agencies and shared data centres.

The Financial Business Act implements parts of both Directive 2006/48/EC and Directive 2006/49/EC and a number of other directives.

The Financial Business Act is supplemented by a series of administrative regulations (*bekendtgørelser*) that implement the corresponding parts of those directives. These include *bekendtgørelse om kapitaldækning*, see most recently *bekendtgørelse nr. 1399 af 16. december 2011*, *bekendtgørelse om store engagementer*, see most recently *bekendtgørelse nr. 1058 af 17. november 2011*, and *bekendtgørelse om opgørelse af basiskapital*, see most recently *bekendtgørelse nr. 764 af 24. juni 2011*. Large parts of the implementation of the CRD IV framework will be made through changes to those regulations.

As in the other Nordic countries the legislative process in Denmark extends over a longer period of time. When the text of the Directive is final there will be made a draft of legislative amendments. The bill is sent for consultation in the public and with stakeholders, including relevant organizations. The political process starts prior to the hearing, as the bill is submitted to the relevant members of the government before the consultation. The consultation period will typically be 6 weeks – in particular cases this may be shorter.

The work with the CRD IV framework obviously has a lot of attention from the relevant financial associations in Denmark and there has been an ongoing dialogue with eg *Finansrådet* throughout the course to the extent that it has been possible to forward information about the work. *Finansrådet* is an organization for banks in Denmark. The members of *Finansrådet* are banks, savings banks, cooperative banks and Danish branches of foreign banks.

After the consultation period the political process continues. The bill is subsequently submitted to the Parliament (*Folketinget)*, where the bill is read 3 times with an opportunity for discussions in parliamentary committees in between readings before the bill is passed. The reading of a bill will typically last for 2-3 months. However, in specific cases, notably in the handling of the financial crisis, *Folketinget* has dealt with bills in much shorter time.

The process of administrative regulations (*bekendtgørelser*) is shorter, since these should not be considered by the Parliament, but can be issued by administrative authorities. In relation to the regulation of financial firms that will primarily be *Finanstilsynet*. A draft for the administrative regulation must be sent for consultation in the public and with stakeholders, including relevant organizations. The typical consultation period for administrative regulations is 4 weeks – in particular cases this may be shorter.

Finland

The current EU banking legislation has been transposed into Finnish law by the Credit Institution Act of 2007, a number of governmental decrees issued by the Ministry of Finance and a substantial set of supervisory standards. The current Act will need to be replaced by a new Act to transpose the CRD IV package. Also the governmental decrees will need to be replaced by new ones and most of the supervisory standards repealed. A new governmental decree and a new supervisory standard will need to be issued to transpose the details of the Directive regarding the countercyclical buffer.

The preparatory work is carried out by the Ministry of Finance, assisted by an informal working group consisting of the representatives of the Ministry of Finance, the FSA, the Bank of Finland and the industry. A draft government proposal will be published for consultation in the autumn, with a view to submitting the final Government Proposal to the Parliament in the beginning of its spring season in early February. The new legislation is intended to enter into force mid-2013.

Iceland

Several laws and regulations span the legal framework of the financial sector. The main legislation is Act No. 161/2002 on Financial Undertakings, with amendments such as amendment Act No. 119/2011, regarding Capital requirements and Risk Weighted Assets of Financial Undertakings which inter alia strengthened the definition of equity. There is also some secondary legislation derived from Act No. 161/2002, such as rules No. 215/2007 regarding Capital Requirements and rules No. 216/2007 regarding Risk Weighted Assets of Financial Undertakings. EU directives 2006/48/EC and 2006/49/EC have been implemented into the Icelandic legal order in Act No. 161/2002 as well as in some secondary legislation.

In March 2012, the Ministry of Economic Affairs published a report on the *Future Structure of the Icelandic Financial System.* In this report, the Icelandic financial system is closely examined from an economic and legal perspective, with a focus on the build up to the financial crisis in Iceland. The report also includes proposals for necessary amendments to Icelandic legislation, including rules regarding capital requirements of financial undertakings. A committee under the auspices of the Ministry of Economic Affairs is currently working on the implementation of the CDR IV framework.

Norway

The Norwegian Banking Law Commission, which was appointed by Royal Decree of 6 April 1990, presented a draft for an integrated Act on Financial Undertakings and Financial Groups etc. on 27 May 2011 (Report No. 24, NOU 2011: 8). The Ministry issued a public consultation on the report 31 May 2011. The consultation was closed for comments on 30 September 2011.

The objective for the legislative work has been to design a draft law that will constitute a structured and orderly modernised and robust regulatory system for the financial undertakings' institutional affairs in the broad sense. The key parts of the draft law concern licensing requirements, market access and licence consideration, capital adequacy requirements, organisational matters and paramount requirements for sound operations, plus structural and corporate changes. The draft law thus involves a summary, in statutory form, of

the main lines of the public-law regulation of the key financial undertakings, financial groups and collaborating financial groups, and key provisions that are currently contained in the statutory regulations system.

In accordance with this, the draft law has been formulated with a view to the repeal of a large part of the current institution-specific legislation deriving from various epochs. This applies to both Banking Acts of 1961 and to the Guarantee Schemes Act of 1996, plus the institutional parts of the Financing and Insurance Activities Acts and of the legislation on payment undertakings and electronic money undertakings. The implementation of the draft law will mean abandonment of the two-track approach that used to characterise financial legislation, and will mean a substantial pruning of applicable financial legislation.

The Banking Law Commission has laid considerable weight on securing a coordinated implementation in Norwegian legislation of the EU/EEA regulatory system in the financial-services field, including implementation of new requirements for Norwegian legislation from changes in the Credit Institutions Directive, the new Insurance Directive and other new EU/EEA legislation in the financial-services field. The draft law proposes solely the enshrining in statute of the main elements of the EU/EEA regulatory system, and the draft contains provisions for implementation of the insurance directive. As EU/EEA financial legislation is, comprehensive, detailed and often complicated, and moreover subject to frequent changes and further development. The draft law has therefore incorporated authority in the statutory regulations for the implementation of present and future EU/EEA regulation.

Moreover, the Ministry on 24 October 2011 issued a public consultation on a memorandum from Finanstilsynet, also containing draft rules for the implementation of new EEA rules corresponding to the CRD IV rules, with a deadline for comments on 6 January 2012. As mentioned in the Ministry's consultation letter of 24 October 2011, the Ministry envisages incorporating new EEA rules corresponding to the CRD IV rules into the new Financial Undertakings Act, which is to be based on the draft proposed by the Banking Law Commission in the NOU 2011: 8 report. The Ministry aims, depending on the adoption of the CRD IV in the EU, to submit a proposition to the Storting on the new Financial Undertakings Act in the autumn of 2012.

Sweden

Implementing the CRD IV framework is likely to be an extensive legal process in Sweden. Partly because the Swedish legislative procedure is time-consuming, as it, *inter alia*, includes a public consultation period of not less than three months, usually takes 12-18 months to complete. A telling indication of this is the number of legal acts presently in play regarding the issues covered by the CRD IV framework.

Despite this extensive scope of legal acts affected by the new framework, the commission analysing the overall implications of implementing CRD IV is expected to deliver its results, including drafts of the necessary legislative changes, on 1 October 2012.

The basis for the current Swedish legal requirements on the functioning of banks, credit institutions and securities firms are a number of laws. EU directives 2006/48/EC and 2006/49/EC have been implemented into Swedish law by the government bill *Nya kapitaltäckningsregler (prop. 2006/07:5)*.

In addition, the government bill *Ändrade kapitaltäckningsregler (prop. 2010/11:110)* specifies how a number of EU directives have been implemented into Swedish law.[25]

General provisions relating to the pursuit of credit institutions are specified in *Lagen (SFS 2004:297) om bank- och finansieringsrörelse* and *Lagen (SFS 2007:528) om värdepappers-marknaden*. The regulation on capital adequacy and large exposures is placed in *Lagen (SFS 2006:1371) om kapitaltäckning och stora exponeringar, Lagen (SFS 2006:1372) om införande av kapitaltäckningslagen* and in *Förordning (2006:1533) om kapitaltäckning och stora exponeringar*.

Provisions relating to administrative sanctions are defined in a number of laws which govern financial companies. Issues of corporate governance in Swedish listed companies are regulated by a combination of on the one hand statutory rules, and on the other based on self-regulation developed by the business community.

Overall provisions for credit institutions and securities firms regarding general meetings, board of directors, company management, ownership assessment, requirements for risk management and control, etc. are specified in *Lagen om bank- och finansieringsrörelse, lagen (1995:1570) om medlemsbanker, Sparbankslagen (SFS 1987:619), Lagen om värdepappers-marknaden* and *Lagen (SFS 2004:46) om investeringsfonder*.

[25] These include EU Directive 2009/83/EG of 27 July 2009 regarding technical provisions concerning the handling of risk, EU Directive 2009/111/EC of 16 September 2009 regarding changes in other directives, and EU Directive 2010/76/EU of 24 November 2010 amending Directive 2006/48/EC and 2006/49/EC regarding capital requirements for trading book, securitization and overall supervisory assessment of remuneration policies.