MEMO

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Summary of the preliminary impact calculations of the Basel Committee's expected recommendations concerning capital requirements for credit institutions

Summary

The Basel Committee is expected to publish a set of recommendations concerning capital requirements in credit institutions. Together with previously published documents on among other things market risk these recommendations constitute a larger set of changes that potentially can have a significant impact for the capital requirements in Danish credit institutions, when they are implemented in the European Union.

The Danish Minister of Industry, Business and Financial Affairs have set up an expert group with the main goal of establishing an overview of the impact of the recommendations on the Danish credit institutions and identify material Danish interests in the recommendations.

This memo is a summary in English of the full memo. The full memo in Danish can be found here: http://em.dk/nyheder/2017/08-11-kapitalkrav.

The preliminary impact of the full set of recommendations in this memo is based on directions and guidelines from the Danish Financial Supervisory Authority. There are significant uncertainties surrounding the impact calculations. Several of the Basel Committee's recommendations are not final and there are still negotiations between the member countries of the committee. The impact calculations are based on the expert group's expectations to the final recommendations. The recommendations concerning market risk are included in the form suggested by the European Commission in connection with a review of CRR/CRD in the preliminary impact assessment.

The expert group's preliminary assessment is an increase in the order of DKK 64-92bn for the largest Danish institutions, if the Basel Committee's recommendations are implemented as assumed in the calculations. The in-

crease corresponds to an increase of 27-39 percent compared to already known future capital requirements. The significant size of the interval mainly reflects the uncertainties surrounding the final recommendations from the Basel Committee. The assessment is based on reports from the five largest Danish SIFIs[1]. The Expert group has not assessed the impact on the capital requirement for small and medium sized institutions.

The expert group's calculations show that the increase in capital requirement largely is due to the so-called floor on risk-weighted assets. This floor only affects the institutions using internal models when calculating capital requirements. This include all Danish SIFIs. If the internal models result in a lower capital requirement than the floor, which is based on the revised standardised approach, the floor replaces the result from the internal models.

In addition, the expert group's calculations show that recommendations will increase the capital requirements for both specialized mortgage institutions and banks. The increases in capital requirement are thus driven by a floor based on the standardized approach which will lead to increases in capital requirements for most of the portfolios in the institutions. The calculations also show that mortgage loans to both households and corporates will be relatively more affected than other risk areas. Beyond this, it is especially corporates and market risk that will experience larger increases in capital requirements. Further information on the effects can be found in the appendix.

Overall, the expert group assesses that there are reasonable parts in the Basel Committee's expected recommendations. The recommendations secure a continuation of the possibility of applying internal models for capital adequacy purposes and a more risk sensitive standardized approach. At the same time the framework for using the internal model is tightened and the internal models for market risk have become more risk sensitive. This can lead to more robust models and thus increase trust in institutions' capital levels. The work on increasing trust in internal models also complements the work in the European Banking Authority, EBA, who among other things works on strengthening the IRB approach in the European institutions.

At the same time, the expert group assesses that the expected risk weight floor is too restrictive. The floor will not only lead to significant increases in capital requirements, which do not reflect the actual risk, but the floor will also lead to a decrease in the capital requirement's risk sensitivity. When the capital requirement is determined by the floor the capital charge will be less

[1] The calculations are based on reports from Danske Bank, Nykredit, Jyske Bank, Nordea Kredit and Sydbank. These five institutions cover the majority (85 percent) of the total Danish banking and specialized mortgage sector.

sensitive to the actual risk in the portfolio. This can remove some of the incentive to lend to low risk obligors. This can in turn lead to an increase in risk and have negative consequences for the financial stability.

It is important to highlight that the expert group does not question the value of having a form a lower limit for the capital requirement. However, such lower limit should be a backstop for and a supplement to the risk based capital requirements. The expert group's assessment is solely based on the fact that the lower limit is set so high in the Basel Committee's proposal, that the internal models will be suspended and the floor will be the binding requirement for most Danish SIFI, including the specialized mortgage institutions. Mortgage loans will be relatively more affected than other risk areas. However, the capital requirements for corporates and market risk will also increase significantly. The expert group finds, that the upcoming leverage ratio requirement of 3 percent to a high degree will address the same concerns as the expected risk weight floor.

Concerning the suggested elements in regards to market risk the expert group finds that they are adjusted in an appropriate direction in the proposal from the European Commission compared the Basel Committee's original recommendation. However, the proposal from the European Commission does not take sufficiently account of the Danish fixed exchange rate policy and the agreement with the European Central Bank of a deviation between DKK and EUR of +/- 2.25 percent. Furthermore, the historical low market risk for mortage-backed bonds is not reflected, as the historical high quality is not recognized.

Appendix – impact calculations

The expert group's assessment of an increase in capital requirements of DKK 64-92bn shows that the Basel Committee's recommendations expectedly will have a significant effect for Danish credit institutions. The recommendations imply several changes compared to the current legislation, but in essence it is the risk weight floor that is the main cause for the increase in capital requirements.

Since the risk weight floor covers all types of risk, the expert group has further examined where the largest effects can be found. The expert group finds that the capital requirements especially increase for loans in specialized mortgage institutions to both households and corporates. In addition to this it is especially corporates and market risk, that will experience large increases in capital requirements.

Table 1 below shows the calculated increase in capital requirements using different assumptions. The calculations for loans in specialized mortgage institutions is based on reports, where the groups have carved out the effect for loans in specialized mortgage institutions.

Table 1 – Increase in capital requirements: Total effect and of which specialized mortgage loans

DKK bn (relative increase inpercent.)	*- Outputfloor 70 pct. - Reduction of market risk 35 pct. - CRR2/Basel SME discount*	*- Outputfloor 75 pct. - Reduction of market risk 20 pct. - CRR2/Basel SME discount*	*- Outputfloor 75 pct. - Reduction of market risk 20 pct. - Basel SME discount*
Group	64 (27 pct.)	85 (36 pct.)	92 (39 pct.)
-of which specialised mortage loans	*32 (46 pct.)*	*39 (55 pct.)*	*N/A**

*The reports concerning specialised mortgage loans do not include calculations concerning the Basel SME discount.

The expert group's preliminary calculations show that the increase in capital requirements mainly is due to an increase in capital requirements for credit risk, cf. table 2.

It is important to highlight, that the calculations behind table 2 is on group level. Hence, it covers both loans in specialized mortgage institutions and in banks. The effect in table 2 thus cannot be added to the effect in table 1. The reports behind the calculations is on group level. It is the total effect from loans in the specialized mortgage institutions on group level that is carved out in table 1 and it is thus not possible to split the effect from for instance corporates in banks and specialized mortgage institutions.

*Table 1 – Increase in capital requirements: Total effect distributed on risk types**

DKK bn.	- Outputfloor 70 pct. - Reduction of market risk 35 pct. - CRR2/Basel SME discountt	- Outputfloor 75 pct. - Reduction of market risk 20 pct. - CRR2/Basel SME discount
Group	64	85
- Credit risk	61	75
- Of which large corporates	*29*	*34*
- Of which SME	*6*	*8*
- Of which mortgage loans	*21*	*24*
- Of which other	*5*	*9*
- Market risk	6	13
- Operational risk	-3	-3[2]

*Credit risk is not specified with the Basel SME discount

[2] The negative effect for operational risk in table 2 is caused by the output floor being calculated as an aggregated floor across risk types. 75 percent (floor) of the expected future requirement under the standardized approach for operational risk is lower than the current requirement for all institutions and hence it appears as a decrease of the capital requirement.