Z E N T R A L E R K R E D I T A U S S C H U S S

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Zentraler Kreditausschuss Position Paper on the Consultative Document of the Basel Committee "Strengthening the Resilience of the Banking Sector"

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A. General observations

The German credit industry in principle supports the efforts of the international supervisors for higher capital requirements in fields in which the crisis has shown the regulatory capital requirements to have been too low, such as in the trading book or in the case of (re-)securitisations. Nevertheless, in our opinion, there is no alternative to a capital regime based on an individual risk profile, in accordance with the fundamental concept of Basel II. Flat-rate assessments – such as, for example, the introduction of a leverage ratio – have no place in a future capital regime, on account of the associated misdirected incentives and possibilities for capital arbitrage, and entail the hazard that the risk-sensitive rules of Basel II will be abrogated. Moreover, they have a blanket effect on all commercial activities and, through higher lending rates, also affect relatively low-risk business fields (e.g. retail customers). An appropriate risk-sensitive review of the capital requirements in our view also renders flat-rate increases superfluous.

I. Expected microeconomic and macroeconomic effects

The regulatory innovations proposed in the Consultative Document will have massive effects on the own funds and risk situation of the credit institutions and therefore on their earnings situation. However, this is not all; serious macroeconomic effects are also to be expected. Erosion of the capital base through more stringent recognition criteria will bring about a reduction in the supply of credit to the real economy. The likewise conceivable reaction of the credit institutions to increase their own funds considerably will lapse for the time being, on the grounds that the Basel, Brussels and national regulators are presenting ever new regulatory proposals for institutions, with an impact on the earnings situation of the institutions which is now incalculable. Investors will therefore refrain from investing in a sector with such diffuse earnings prospects.

The tightening of credit will gather further strength if the leverage ratio under discussion proves to be the narrower concept in terms of its mode of operation in relation to the risk-weighted own funds provisions. It is also possible that, with a configuration of this kind, the institutions will have evasive reactions to higher-risk business which are not recognised by a non-risk-sensitive leverage ratio.

Furthermore, the measures covered by the consultation lead to a clear increase in the risks to be underpinned by own funds. In particular, the proposals to cover the counterparty credit risk will increase the capital requirements considerably, thereby creating further pressure on the scope for lending.

These effects cannot be estimated sufficiently reliably by the currently extremely ambitious comprehensive quantitative impact study. Therefore, in our view, it is absolutely essential to pay attention to two factors with regard to the potential introduction of the new rules:

1. There is a need for a grandfathering clause of at least 30 years for own funds instruments which are recognised as such under the current rules in order to give the institutions time to adjust to the new conditions and to avoid provoking friction in lending. Within these 30 years, there must be a period of at least 10 years of unrestricted grandfathering. After this, a period of declining may occur. Naturally, the reference date for the financial instruments which are to come under the grandfathering clause, for reasons of legal certainty alone, can only be the date of the publication of the final Basel regulations and not the publication date of the Consultative Document. Otherwise, considerable uncertainty would arise in the capital markets which would make it impossible to raise new capital. Furthermore, the transitional regulation established for Europe in connection with the revision of the CRD in 2009 must not be jeopardised.

2. Gradual entry into force of the measures discussed here and in the Basel Consultative Document "International framework for liquidity risk measurement, standards and monitoring" is of equal importance. Various packages of measures should be defined and enter into force at different stages with a period between them of at least a year, so that the actual effects can be observed in practice. In addition, simultaneous application of two measures with the same effect should be avoided, such as, for example, new qualitative own funds requirements and leverage ratio.

II. Lack of possibility to calculate the quantitative effects – unclear cumulative cause and effect relationship

Essential requirements of the Consultative Document – such as the calibration of the leverage ratio or the minimum percentage of common equity component in the Tier 1 capital to be required in the future – lack a precise quantitative definition. If the parameters are not fixed, however, calculation of the quantitative effects is not possible. The "Quantitative Impact Study" (QIS), which is running until the end of April 2010, therefore is not worthy of its name in our view. Rather, this is a complex data collection exercise, with the ultimate objective of placing the international supervisors in the position to be able to calculate the overall quantitative effects under various scenarios for the core elements of the Consultative Document. Moreover, so far there is a lack of ideas concerning the scale on which the planned improvement of the capital adequacy of the international banking system is to be achieved. There is no clear objective or yardstick. In the Basel II process, for example, the capital requirements were calibrated so that the level of capital in the system was kept constant. The huge number of parameters and their in some cases serious effects allow for each politically desired increase in capital adequacy. Policy specifications are necessary here, since the appropriate level of capital adequacy cannot be inferred either in theory or in practice. With such a specification, the international supervisors must always bear in mind which microeconomic and macroeconomic effects can still be tolerated.

Since the proposed amendments have such a massive impact on the credit industry and consequently on the economy as a whole, we consider it essential, after the final regulations have been drawn up, to carry out a

further consultation with a simultaneous QIS in order, if necessary, to be able to undertake fine-tuning of the regulations and their introduction. In this respect, the QIS should contain a **thorough investigation of the economic effects of the proposals** on the lending potential of the banks and therefore on the real economy. The results of such an investigation must be considered in the calibration of the final regulations.

III. Implementation of the new specifications must be in step internationally – avoidance of serious distortions of competition

Apart from the gradual introduction of the package of measures, it is equally important for the specifications of the Basel Committee to be introduced simultaneously by all members to avoid serious distortions of competition. In any case, Basel II must be introduced in full in all relevant Member States of the Basel Committee – this applies both for the determination of the risk-weighted assets (RWA) and the consolidation provisions of the framework agreement for risks and capital. Since in the past there were justified doubts about the will of individual members to implement the Basel specifications in accordance with the schedule, the possibility should be created for individual jurisdictions, but also the European Community, with reference to the non-implementation in other member countries, to be able to provide for a deferment of the implementation.

B. Individual comments

Below, we comment on the individual passages of the Basel Consultative Document.

I. Executive summary

2. Strengthening the global capital framework

(e) Addressing systemic risk and interconnectedness

Points 46-49

In principle, we agree with the Basel Committee that systemic risks were not given sufficient consideration in the regulations prior to the financial market crisis. We therefore welcome the fact that systemic risks in future are to play a greater role in the considerations and actions of the bank supervisors. To reduce the probability and the significance of systemic crises, micro and macroprudential supervision must be more closely interconnected and the cooperation between international supervisors improved. Structures are therefore necessary which allow identification and quantification of systemic risks and development of suitable measures to avoid or at least mitigate them. Tasks of these macroprudential supervisory institutions would include identifying imbalances on markets, common sources of risk and interconnectedness of the market participants, and deriving risk mitigation measures. The planned establishment of macroprudential

supervision in Europe in the form of the European Systemic Risk Board (ESRB) is a step in the right direction.

In setting the aim of especially addressing systemic risks, however, the prudential principle of “same business, same risk, same rules” should not be overlooked. This means that special requirements, for example regarding capital and liquidity adequacy, are justified only where the nature and scope of the exposures entered into justify systemic relevance.

However, the identification of systemically important banks and the assessment of the individual contribution of an institution to the systemic risk give rise to considerable practical problems. The financial market crisis has impressively shown that the identification of market participants capable of jeopardising financial market stability is very difficult. The size of an institution is not the only decisive factor here. The FSB, BIS and IMF recently singled out preliminary criteria to assess the systemic importance: size, interconnectedness and substitutability, which are to be supplemented on the basis of further findings. The guidelines clearly show that, to determine systemic importance, the respective economic framework conditions consequently also have to be considered. This makes the objective identification of systemically important institutions difficult. Also the procedures to quantify the systemic risk are currently under scientific discussion. This discussion focuses on model-based (e.g. CoVaR) versus ratio-based heuristical methods. The former have not so far matured very far and are presentable for the financial system as a whole only with a great deal of effort. For the use of ratios, suitable indicators have to be identified and calibrated.

Point 48: We view critically the introduction of a factor of 1.25 in the calculation of the risk-weighted exposure values, in so far as exposures to unregulated market participants or institutions with total assets exceeding USD 25 billion are involved. We do not believe that this will allow sustainable diversification effects to be achieved. The regulation will lead to refinancing becoming more difficult, and at the very least more expensive, for big banks (USD > 25 billion total assets), since to refinance on the interbank market, more own funds would have to be held, for example in the rating class “A” relevant here about 35%. It is to be assumed that these costs are considered in lending, leading to perceptible effects for the real economy. We are therefore rather doubtful that the proposed measures will in fact reduce the systemic risk.

Clearing suitable derivatives transactions through central counterparties (CCPs) to a greater extent certainly offers a series of advantages and can in principle reduce contagion effects on account of the high degree of interconnectedness of the market participants. However, it must be ensured that greater use of CCPs does not give rise to new systemic risks. If competition strengthens between different CCPs, this must not be at the cost of the quality of the risk management. The original intention to increase market stability could be impaired by competitive effects of this kind. In this respect, not only the introduction but also the effective maintenance of high standards in risk management of the CCPs is absolutely essential.

Point 49: The comments of the Basel Committee make it clear that the academic discussion on systemic risks has to be continued further. In this respect, it is important to avoid snap conclusions. Methods, instruments and processes should be developed on the basis of scientific approaches and their effects on the financial industry analysed. The results of both the Basel Committee and the FSB can facilitate the establishment of macroprudential supervision.

II. Strengthening the global capital framework

1. Raising the quality, consistency and transparency of the capital base

Points 60 - 109

Preliminary observations

Following the events of the financial crisis, we can understand the Committee's first steps towards strengthening the quality and quantity of the regulatory capital base. However, this can only mean increasing the loss absorption capacity in the event of crisis. Nevertheless, the Document gives the impression that the crisis would not have happened if the credit industry had entered it with more capital of better quality. This is highly debatable, since the **crisis was triggered by a liquidity shortage arising from a fundamental lack of confidence**, the consequences of which the system would have not been able to absorb even with more and better capital.

It is also striking that the Basel Committee, before the publication of its proposals, carried out no **investigation** on the triggers and driving factors of the crisis with a particular focus on the importance of capital in this respect. If an investigation did take place, the Committee did not communicate the results either to the public or to politicians. This procedure is in clear contrast to the approach opted for in Europe, where a review of the hybrid capital instruments eligible as capital was preceded by a series of studies.

According to the regulatory adjustments, the bulk of the Tier 1 capital is in future to consist of common equity (point 82). In the side letter to the G20 Summit, the Financial Stability Board proposed a range of between 50% and 85%. The qualitative requirements regarding core Tier 1 and additional Tier 1 capital instruments have already been raised sufficiently. In our view, additional tightening up of the limits for recognition is unnecessary. In this respect, we expressly advocate retaining the current maximum limit of 50% for additional Tier 1 instruments. Otherwise, unlisted institutions with no access to the capital market would be heavily penalised. For these institutions in particular, additional Tier 1 capital is often the only possibility of obtaining Tier 1 capital in the short term. This flexible capital procurement option is essential for these institutions.

General observations on the principles for common equity

The principles-based definition of the common equity component of Tier 1 is in our opinion understandable and brings about desirable international standardisation. The conditions of recognition focus on the principles of permanence, loss absorption and flexibility of payments, which is reasonable in our view, since this focus ensures capital of high quality.

To round off the principles based appraoch, the Basel Committee provides in footnote 19 that instruments which are "deemed fully equivalent to common shares in terms of their capital quality as regards loss absorption and do not possess features which could cause the condition of the bank to be weakened as a going concern during periods of market stress" are also to be recognised. We expressly welcome this, since this footnote establishes a link between principles orientation and the need for recognition of such core capital instruments which have proved their suitability as capital instruments for non-joint stock companies in the past.

Against the backdrop of the principles based appraoch, it is not however comprehensible to us why this approach is not consequently followed with regard to the recognition of common equity instruments since it is exclusively equity and reserves which are recognised as core Tier 1 instruments for joint stock companies. In our opinion, there is no justification for this from the prudential point of view. We strongly oppose the planned unequal treatment of different legal forms and therefore as a result the less favourable position of joint stock companies compared to non-joint stock companies. So long as core capital instruments meet the 14 principles drawn up by the Basel Committee, it is in fact totally unimportant whether this instrument is a common share or any other form of capital. The decisive factor for classification as core capital must be the quality of an instrument, not the legal form of the issuing bank. As long as from the point of view of the Basel Committee there are no valid reasons for a distinction according to legal form, we call for financial instruments other than just equity to be eligible for joint stock companies too.

Limitation of the common equity to subscribed capital and disclosed reserves would also render reorganisation measures in the banking sector considerably more difficult. For example, in the case of the change of a credit institution's legal status to the legal form of a joint stock company, forms of capital which satisfy the new common equity requirements would no longer be eligible.

Furthermore, banks must be given the possibility of diversifying their capital base, as is recognised for example, in the Sydney Press Release. This applies in particular to the diversification with regard to currency in which the instruments can be issued. Since common shares as a rule, according to company law,

can only be issued in the respective home country in the respective currency, limitation to these instruments would be counterproductive.

We welcome the clarification in footnote 16 to point 85, according to which provision is made for the application of the planned future capital structure at both solo level and at consolidated group level including bank holding companies. This proposal on the scope of application of the new regulations will contribute to avoiding distortions of competition.

In this connection, however, it is in no way sufficient to harmonise only the scope of application of the new capital rules. To ensure a true level playing field between the competing institutions, it is necessary, with a view to bank holding companies, in connection with the currently pending fundamental review of the definition of capital, to ensure that the important issue of a uniform application on consolidated level is clarified with binding effect. The approach arising from footnote 16 to point 85 for the capital rules to be applicable to bank holding companies fall short, in so far as only the inclusion of these structures in the existing consolidation provisions would enable the uniform specifications on the capital structure to have material effect. We therefore expressly advocate closing the existing loopholes in the field outlined now and in this way ensuring equal conditions of competition for all institutions.

Finally, it still has to be borne in mind that, considered internationally, tax provisions are to a large degree heterogeneous and accordingly in no way comparable. Therefore the consideration of instruments under tax law should not play a role. The quality of capital is not dependent on its tax treatment (point 76). The same applies for the **voting rights** attached to an instrument. We therefore welcome the fact that in the criteria for the eligibility of common equity components, the focus is not to be placed on the voting rights attached to an instrument. Voting rights are not detrimental to the quality of the capital, provided that the instrument satisfies the criteria for common equity.

Specific observations on the principles for common equity (point 87)

Principle No 5: We strongly reject the specification that no cap is to be allowed and also the amount of the distribution may not depend on the amount paid in. Fixed and maximum interest rates have no impact on the quality of the capital, provided that the distribution is at the sole discretion of the issuer and the payments are made on a non-cumulative basis. This already sufficiently ensures the necessary flexibility of the payments. The deletion of the second sentence would therefore be appropriate.

Principle No 6: Full discretion of the management concerning dividends and coupons is too far-reaching. The underlying assumption is apparently that this discretion is a characteristic of the common shares and

that any other instrument of the common equity must have precisely the same characteristic. The assumption that the discretion of the management of a bank to be able to take the decision on payment of the coupon on an “as needed” basis is one of the key characteristics of the common stock, is incorrect – in any case in many European jurisdictions.

It is true that this is correct for the USA, where the board draws up the annual accounts and sets a dividend on the basis of its business assessment, but the laws and practices in Europe are different. Only drawing up the annual accounts is entrusted to the management. The decision on payment of a dividend is passed on to the shareholders. If the shareholders decide in favour of distribution, the company is committed to it. If the requirements under company law on distributions are complied with, only the supervisor can intervene with its rights to take decisive action to suspend the payment. Against this background, not even ordinary shares in Europe meet the common equity requirements proposed by the Basel Committee.

In view of the fact that in Europe not even the common stock is at the full discretion of the management, criteria 6 of point 87 and 7 a) of point 89 must be amended. In our view, a verification of whether profits eligible for distribution exist would suffice for instruments to be considered as common equity:
“ Distributions may only be obligatory if
a. the annual profit of the most recent fiscal year for which audited financial statements are available are equal to or larger than the amount of the envisaged distribution and other distributions and
b. the solvency ratio of the bank is well above the minimum requirements (i.e. the institution is “well capitalised”) and
c. there is no order of the regulator that suspends the payment.
The well-capitalised threshold can be established in the context of the prudential review process under Pillar 2.

Principle No 7: This criterion explicitly excludes preferential distributions. In contradiction with this, however, footnote 15 expressly mentions that some admissible classes of common shares may have certain debt-like features, such as preferential dividends. We advocate resolving this contradiction by amending criterion 7 along the lines of the regulatory content of footnote 15, i.e. authorising preferential distributions, since they have no adverse effect on the principles of loss absorbency, permanence and flexibility of payments. In our opinion, it would suffice to clarify that the prohibition of preferential treatment is not to be related to the amount of the distribution – which is essential to compensate for the non-existence of voting rights – but only to the order in which the distribution is made. It should therefore be ensured that preferential payments are of equal ranking and proportionally uniform (pari pasu) to payments on common stock. “[...] This means that there are no preferential distributions REGARDING THE ORDER OF PAYMENTS, including in respect of other elements classified as the highest quality issued capital.”

Principle No 10: The criterion requires that the paid-in amount is classified as equity under the relevant accounting standards. In principle, we view the link between accounting and prudential treatment critically. The definition of capital elements which are usable for prudential purposes is thereby increasingly placed in the hands of external standards-setters. Since the accounting standards have to be adjusted very frequently, dependence on this is associated with undesirable volatility for the prudential capital. This cannot serve the purpose of banking supervision. Excessively strong dependencies should therefore be viewed critically.

Principle No 11: Under this requirement, the instrument must be directly issued and paid up. By requiring direct issue, instruments issued via an SPV obviously are in future no longer eligible as common equity. In so far as only fully paid-up instruments are to be recognised and the principle of the actual putting up of capital is adequately met, the issuing channel in our view is unimportant, however.

Rather, it must continue to be possible to issue capital indirectly too. This is especially important against the background that institutions from smaller currency areas otherwise would experience considerable problems in raising capital (also see our “General observations on the principles for common equity”). The Committee is also not hostile in principle to possibly raising capital indirectly. We therefore advocate formulating principle No 11 to correspond to principle No 14 for the additional core capital.

Principle No 14: In our view, it is more logical to focus not on disclosure in the balance sheet but rather on the disclosure requirements (pillar 3).

Specific observations on the principles for additional Tier 1 capital (point 89)

Principle No 4: The additional Tier 1 capital is limited in amount by the requirement that common equity should constitute the predominant part of Tier 1 capital and accordingly is of somewhat lesser quality than common equity. At the same time, however, it undoubtedly meets the high requirements which justifiably are laid down for loss absorbency, flexibility of payments and permanence. In our opinion, it would be appropriate also to allow within this category deposits made available for a long, but nevertheless limited period (e.g. with a term of 30 years or more), as well as innovative instruments. This would correspond to the implementation in Europe, which allows a proportion of 15% of core capital for such instruments. The fact that the capital components may be redeemable is recognised by the Committee itself by granting the institutions the possibility to redeem capital instruments subject to prior supervisory approval. Fixed-term capital instruments as well as innovative instruments, which at the same time satisfy the other principles drawn up by the Basel Committee, are of sufficient quality to be recognised as Tier 1 capital. To avoid redemption on maturity of the capital instrument occurring at an inappropriate time, for example because the institution is in a crisis, a reservation of supervisory approval can be incorporated.

In this respect, we advocate synchronisation with the European regulation. In our opinion, the European provision according to which fixed-term and innovative instruments are eligible up to a limit of 15% is a good compromise between the investors' need for flexibility and the interest of maintaining prudential capital.

Principle No 5: The supervisory approval is necessary inter alia when exercising the right of redemption. In order to allow the institutions security of planning, the supervisor should lay down certain conditions on which supervisory approval is granted.

In line with our request concerning Principle No 4, the requirement under point b) should be deleted.

Principle No 6: In our view, the supervisory approval could be dispensed with, if capitalis replaced by capital of the same quality and term. No deterioration occurs either from the point of view of the investors or from the point of view of the supervisors so obtaining supervisory approval only occasions bureaucratic expenditure without recognisable benefit.

Furthermore, we advocate simplified buy-back of capital components which on account of the "predominant" requirement of common equity are no longer eligible as additional Tier 1 capital. Here the institution would otherwise be forced to incur higher expenditure without corresponding benefit, which in turn weakens the yield situation.

We assume that market-making activities will also be authorised in the future and not stand in the way of the eligibility of the capital instruments.

Principle No 7, point a: According to this criterion, the payments must be structured in such a way that the institution has full discretion at all times to cancel distributions. We consider that the requirement that coupon payments must be subject to full discretion goes too far where additional Tier 1 capital instruments are concerned and therefore advocate deletion of this requirement. Instead, the usual verification of whether profits eligible for distribution exist should be applied. This entails that either a sufficient annual surplus or a sufficient net earnings must be available for distribution. In some cases, this condition is combined with a prudential capital adequacy requirement. Furthermore, we refer to our comments on criterion 6 of the common equity criteria.

Principle No 7, point d: According to the criterion, "dividend stoppers" do not stand in the way of eligibility of capital instruments. We ask for clarification that consequently "dividend pushers" will also continue to be admissible.

Principle No 9: According to this criterion, instruments cannot have a credit-sensitive feature for the payment of dividends, i.e. the payments may not depend on the credit standing of the institution. However,

this requirement must not extend to instruments where on the expiry of the fixed-interest period a regular resetting of the interest rate occurs, which in turn is established on the basis of the institution's current credit standing. Such a characteristic should continue to be admissible, provided that it does not conflict with the other principles for additional Tier 1 capital and especially Nos 7 and 8.

Principle No 11: It should be clarified that this criterion is applicable independently of the classification as own funds or debt. With this proviso, we assume that the concept of "liability" refers to the applicable accounting standard. We therefore advocate the deletion of the phrase "classified as liabilities".

In substance, this criterion requires principal loss absorption. The regulations on the write-down mechanism are not formulated clearly with regard to the write-up of the capital and could be interpreted to mean that provision is made only for a permanent write-down for the nominal amount. However, this would in fact place additional Tier1 capital investors in an inferior position to shareholders. At times when the economic situation of the issuer has improved again, shareholders, in contrast to additional Tier1 capital investors, could participate in the success of the undertaking. It should therefore be clarified that in addition to the permanent write-down, a temporary write-down is also possible, in which case the write-up of the capital occurs if a profit is made. Furthermore, clarification is necessary that a write-up of the nominal amount is also authorised in the case of "tax calls".

It should be made clear that a wide range of configurations of triggers for the write-down mechanism is allowed to avoid a systemic risk. Otherwise, in the case of a crisis, the same trigger would be pulled at the same time for all additional Tier 1 instruments and so affect all investors at the same time.

Principle No 12: The formulation of criterion 12 should be brought in line with the parallel formulation of criterion 8 of the list of criteria for inclusion in Tier 2 capital that the institution cannot have **knowingly** purchased or directly or indirectly funded the purchase of the corresponding instruments. By including the corresponding concept it becomes clear that the deduction obligation takes effect only if the institution's conduct has been deliberate. In the absence of such clarification, the corresponding requirement can hardly be met by the institutions, since as a rule the institution, for example in the case of a procurement loan, has no possibility of control at its disposal of how the borrower in fact uses the proceeds of the loan and whether he will for example acquire the institution's capital instruments with them. With the corresponding clarification in criterion 8 of the list of criteria for inclusion in Tier 2 capital, the Basel Committee shows that it has very clearly recognised this problem. In this respect, it is only logical to adapt the parallel criterion under point 11 of the list of additional Tier 1 capital accordingly. The criterion may likewise not oppose a market-support scheme. We therefore request clarification that this criterion is only to ensure that an effective capital inflow is made by a third party and an act of circumvention is excluded. It must be ensured that market support is permitted within certain limits, in so far as the own shares are deducted when determining capital (see point 100).

Principle No 13: We ask for clarification of how this criterion is to be put into operation.

Additional requirements:

With regard to the additional requirements, we refer to our comments on point 101.

General observations on the principles for inclusion in gone concern capital (Tier 2)

Fundamentally, we welcome the principles-based structure of the Tier 2 capital.

Point 92: In our opinion, the reservation of supervisory approval is sufficiently effective. During the financial crisis, some institutions were placed under pressure to buy back own funds in order to avoid losses by investors in these instruments. The reservation of supervisory approval will in future prevent such a development, since the buy-back of the instruments is placed under the express reservation of supervisory approval. However, we refer to our observations on the criteria for additional going concern capital that, in our view, a reservation of supervisory approval at times could be dispensed with.

Specific observations on the principles for the inclusion in gone concern capital (Point 90)

Principle No 4, point c: Since these instruments may have limited maturities, the ban on incentives to redeem (soft maturity) is superfluous. This requirement, like that in criterion 5, point b, should therefore be deleted. It seems more appropriate, in our view, to consider soft maturities in the context of the amortisation rules (criterion 4, point b).

Principle 5, point b: We refer to our comments on criterion 4, point c.

Principle 7: We refer by analogy to our comments on principle 9 for additional going concern capital.

Specific observations on contingent capital (Point 91)

We welcome the consideration given to introducing possible regulations on contingent capital, convertible capital and other instruments with write-down features to accept them within the regulatory framework as capital components and capital buffers. We consider it necessary, in this connection, to include the banking business in the discussion process. In particular, we suggest covering the following aspects in the considerations:

- The purpose of contingent capital should be clarified, as well as which recognition these instruments are given especially before conversion, not only in the Pillar II, but also in the Pillar I context.
- Concerning the structure, the specifications should again as far as possible be principles-based. This is particularly true against the background that the market for these instruments is in the process of developing. The principles drawn up should not stand in the way of the development of this new segment. In the market, for example Lloyds is generating transaction common equity in the form of share capital, whereas Rabobank on the other hand is generating transaction common equity in the form of reserves/gains. In our view, the effect from the point of view of loss absorption potential is the same.

Observations on the regulatory adjustments applied to regulatory capital (Points 93-108)

The entire Tier 1 capital comes under the concept of the "going concern". The criteria developed by the Basel Committee for both parts of Tier 1 capital ensure adequate loss absorbency. In this respect, it would be appropriate to deduct from the entire Tier 1 capital. We can concur only in part with the reference to the accounting principles, made by the Basel Committee to justify differentiated rules for deduction, since so far accounting and regulatory capital diverge. We therefore advocate deducting all deduction positions based on the going concern assumption from the total sum of Tier 1 capital. For deductions which would become virulent only in the case of the gone concern, in our view a deduction from gone concern capital (Tier 2) is appropriate (see observations on points 98 ff.).

Furthermore, the fact that this procedure would facilitate the future management of Tier 1 capital by the institutions argues in favour of a deduction from the sum of the Tier 1 capital. The proposal of the Basel Committee, on account of the expected setting of a higher percentage share of the Common equity component of Tier 1 of the sum of the Tier 1 capital, on the other hand, leads to distinctly more complex requirements regarding the management of own funds. If deductions have to be done on the Common equity component of Tier 1, institutions would have to considerably alter the configuration of the shares of Tier 1 specified via the establishment of predominance in order to avoid components of the additional going concern capital possibly being eliminated from the imputation.

Point 94: In our view, it is incomprehensible to allow the inclusion of an agio (stock surplus, share premium) only in the category to which the corresponding instrument is to be assigned. The agio is received in full by the institution on issuing the instrument and entered as a reserve. It should therefore also be assigned in full to the Core Tier 1 to correspond with this entry. In so far as there were to be diverging rules

in other jurisdictions, these must be taken into account by differentiated treatment. This does not however justify different treatment of individual reserve positions.

Point 95: We reject the planned change in the treatment of minority interests as inappropriate. The proposed rule concerning consolidation imposes on the banks an unjustifiable asymmetry of the assumption of risk in the case of minority interests held by third parties. In consequence of the proposal of the Basel Committee, the consolidating institution would be fictitiously imputed 100% of the risk weighted assets, but no longer – as hitherto –the capital not held by the institution. It is incomprehensible to us that the "risk consolidation" on the one hand and the "capital consolidation" on the other should diverge. As a result of the control relationship between parent and subsidiary, the parts of capital held by third parties can also be used without restriction in the interest and to the benefit of the entire group. The capital of the subsidiaries is therefore available without limitation for loss absorption at group level. Against this background, it should continue to be possible for minority shares held by third parties to be imputed in full to the group capital.

The situation can only be otherwise for the imputation of overcapitalisation of the subordinated entity on the basis of minority interests. For amounts of overcapitalisation of this kind, imputation in the form of additional going concern capital or gone concern capital could also possibly come into question, provided that the criteria drawn up by the Basel Committee are met for these forms of capital. To evaluate whether "overcapitalisation" exists, the capital adequacy of the consolidating entity before consideration of the minority interests should be the relative measurement and not the prudential minimum capital requirements, since the latter will always be stricter than the capital ratio targeted by the management. Amounts which are not imputable to the "overcapitalisation" must therefore continue to remain imputable as Core Tier 1 at the consolidating undertaking.

Point 96: We assume that the proposal to deal with unrealised gains and losses relates only to the positions which are to be allocated to the revaluation allowance in accordance with IFRS. Renouncing filtering is pointless, since this procedure has a strong procyclical effect. Nevertheless, the fact remains that, at least for the IFRS field, such a regulation will at once become superfluous, since the relevant class (AfS) according to the new proposals for IAS 39, will no longer be available – as a result of which the procyclical problem becomes all the more acute. Under no circumstances, however, does it seem appropriate to us to undertake only one-sided filtering of the gains (as also presented in footnote 17).

Points 98 and 99: The tax deferral for accounting purposes is based on the differences between different valuations in the national/international GAAP account and the tax account and, in accordance with the balance-sheet recognition and valuation options on the balance-sheet date, shows the economically correct asset and liability recognition from future tax burdens and tax relief. Deferred tax assets (DTAs) are shown in the balance sheet

a) either because a temporary difference exists between book value and value recognisable for tax purposes of an asset or liability

b) or because a claim against tax authorities to reduce the tax on future profits due to net operating losses (NOL) or tax credits carried forward exist

In the discussion on the eligibility of DTAs in Core Tier 1, it should be clarified beforehand that the eligibility of DTAs resulting from temporary differences (a) is not called into doubt. The amount of DTAs or DTLs arising from temporary differences depends on the differences between the local tax law and the accounting standard to be applied (usually IFRS) to determine the basis of tax assessment and book value. The DTAs or DTLs bring into line the income tax and accounting profit of an accounting period. In other words, they are not based on any grounds other than differing calculation rules.

An important reason for DTAs at banks is the fact that in many tax systems a deduction for credit default provisions is permitted only in the case of realisation of a loss, whereas the accounting deduction is carried out at the time the provision is set aside. A compulsory deduction from core capital for DTAs will cause an undesirable feedback loop if the institutions try to verify and establish appropriate amounts of provision, including with regard to the proposed new EL provisions, if DTAs are to be deducted on temporary differences.

Imputation to the prudential own funds should also be considered appropriate for DTAs on tax credits carried forward or NOL . DTAs from unused carry-forward of tax losses, which in this discussion are often considered to be particularly uncertain, may only be capitalised in so far as sufficient taxable temporary differences exist or other convincing evidence is produced that in future sufficient taxable profits will be available. Furthermore, a special reporting obligation applies on the scale of DTAs on carry-forward of losses and on the evidence produced of probable future taxable profits.

We cannot understand the concern for prudential recognition of DTAs, since capitalisation of deffered tax assets is subject to exacting recognition and valuation conditions. In so far as these conditions for the capitalisation of DTA are satisfied, an accounting asset exists which as such should also be granted prudential recognition.

It is not incorrect to state that DTAs, which are based on past losses of an institution, in the event of the insolvency of the institution will probably not be available to the full extent to secure the claims of creditors. Logically, the values should not therefore be deducted in Core Tier 1, but be deducted for the case of the gone concern and therefore appear only as a deduction in the gone concern (Tier 2) capital.

Moreover, precisely the present crisis shows that DTAs have a significant anticyclical effect and so counteract procyclical effects of the economic climate, prudential rules and accounting principles. Precisely

in the current situation, they prevent the Tier 1 capital shrinking too much, since valuation losses do not have to be shown in full through the partial consideration as DTAs.

Finally, we welcome the clarification that the sum of the DTAs is to be deducted only after being set off in full against all deferred tax liabilities, i.e. without consideration of different jurisdictions or different types of deferred tax liabilities or assets.

Point 100: The ZKA considers the requirement for holdings in index products, which would be classified as a participating interest in the case of a single investment, also to be considered in the deductions to be too far-reaching. The original approach of the deduction rules for own funds consisted in avoiding the construction of capital pyramids. Index products on the other hand are modelled synthetically on an index, but without concrete investment in the products. The construction of capital pyramids is therefore precluded. What is more, capital of banks incorporated in an index will not be lowered. Still, at the same time banks which are included in an index will have comparable disadvanteges since only they will face capital reductions through holdings of index products.

Finally it is highly questionable whether the benefit for the banking system from deduction of an indirect holding of own shares exceeds the additional reporting costs. We therefore propose confining the deduction of own shares to the direct holding of own shares and in this respect advocate the deletion of the passage.

Netting: It remains unclear what is meant by “short positions without counterparty risk”. In the worst case, the regulation would in practice prohibit netting as a whole. We propose permitting the netting of long and short positions in own shares.

Moreover, we ask for clarification that the term “positions” does not refer to any derivatives with cash settlement, since they are not offset against shares and therefore cannot change the own capital. Accordingly, also in accordance with IAS 32, derivatives with cash settlement are not deducted from own capital.

Point 101: For the treatment of non-consolidated participating interests within the financial sector, the Basel Committee proposes a corresponding deduction from the respective tier of capital for which the capital would be classified if it were issued by the credit institution.

In particular, in the case of participating interests within the financial sector of up to 10%, the underlying basis with regard to the tier of the institution’s capital to be used is unclear. We advocate that the entire capital of the institution is used as a basis to determine the limit (10% of the capital of the institution). In addition, by analogy with the present regulation, the gross basis, i.e. the capital before deduction of all positions, should be used.

It remains unclear what is meant by “short positions without counterparty risk”. In the worst case, the regulation would in practice prohibit netting as a whole. The basket (RWA treatment for investments with a total volume of up to 10% of the common stock of the bank) will quickly be used up if the full market-making positions have to be entered in the accounts. The proposal reduces the incentive for banks to reduce the risk from the investment by a mitigating short position. We propose permitting the netting of long and short positions in own shares.

We also reject the planned looking through of index securities to determine the unconsolidated participating interests within the financial sector. This would lead to increased implementation costs for institutions. The banks regularly hold a stock of index securities for the purpose of market-making. Deduction from own capital for investments held indirectly via index securities would therefore increase the costs of market-making. With regard to the amount of the holding, banks nevertheless have an incentive to limit the size of their holdings in order to limit the associated funding costs. It is highly questionable whether the benefit for the banking system arising from a deduction of indirectly held investments outweighs the additional reporting costs.

Furthermore, the regulation proposed by the Basel Committee contains no pronouncement on whether the deduction obligation is to apply only for direct or also for indirect participating interests. If interpreted in the latter sense, it would in our view be necessary at least to clarify to which level (subsidiaries, subsubsidiaries, etc.) the institution would have to “look through”, since a consolidation obligation laid down without any restriction would lead to considerable practical problems for the institutions at the lowest level of participations without substantial improvements at prudential level in fact being achieved as a result. Not least for this reason, we advocate restricting the consolidation obligation to direct participating interests and in this way striking the right balance between the prudential needs and the needs of the institutions concerned in accordance with a practicable organisation of the regulations.

Points 102 and 246: In principle, we can understand the Committee’s intention to provide an incentive for sound provisioning practices by deducting the shortfall from common equity. However, we point out that an institution is already interested from business management considerations in sound provisioning commensurate with the risk. In order however to create symmetrical incentives, we suggest continuing to impute the surplus over the expected loss not to Tier 2 capital , as indicated in point 103, but rather according to the shortfall without restriction to common equity. It is true that provisions are set aside during the financial year, but are approved only for a set-off against the shortfall when the annual or interim accounts are adopted. Consequently, through fluctuations in the expected loss during the year, the institutions are forced to adapt the shortfall calculation without the possibility being given to them to be able to cushion them by building provision during the year. To then burden these institutions with the deduction of the shortfall from common equity is clearly rejected by us.

Furthermore, we consider the proposed procedure to be systematically questionable from business management considerations. The entire own capital is available as a risk buffer to cover the underprovisioned expected loss. In this way, covering the shortfall should at least be possible with the entire going concern capital.

Points 106 and 107: Deduction of defined benefit pension fund assets and liabilities
A deduction would give the banks an incentive to reduce the surplus cover of pension funds to the minimum or even to tolerate under-cover and in this way put the pensions at risk. We propose renouncing the deduction and continuing to monitor the pensions under Pillar 2. If the Basel Committee were nevertheless to be of the opinion that a deduction is necessary, we propose a deduction from Tier 2 capital, because the pension surplus would only have to be disposed of in a gone concern scenario. Furthermore, we request clarification for the case that deduction of a net asset position in CTA structures (contractual trust agreements) only has to occur if it has led to an increase in the bank's own capital and there is no entitlement to the economic benefit from the debit balance of the plan assets of the bank.

Point 108: For the remaining 50 : 50deduction positions, the institution should at least retain the option existing up to now between a capital deduction and an imputation of a risk weighting of 1250% for securitisations.

Observations on the disclosure requirements (points 80, 81 and 109)

In principle, we share the view that extending the transparency obligations can lead to an improvement of the basis of information. However, we point out that too much detailed information for the addressee can easily lead to an overload when it comes to interpretating it. Moreover, in addition to the improvement of the basis of information, competition aspects also have to be taken into consideration. In this respect, the disclosure requirement in points 80 and 81 should generally be confined to the essential information.

Point 80, 1st bullet: Since the regulatory and the balance-sheet capital in principle differ from one another and in portraying the capital, differences also exist between the individual national and international accounting standards, we consider a full reconciliation of the regulatory capital elements back to balance sheet not to be practicable. In addition, a corresponding reconciliation would involve considerable expenditure for the institutions, whereas at the same time we question the greater value of knowledge for the addressee.

Point 80, 2nd bullet: In our opinion, for reasons of information efficiency, only essential regulatory adjustments should be disclosed separately. Disclosure of all adjustments would rapidly lead to an information overload and obscure the view of the essential adjustments.

Point 81: The public disclosure of the full terms and conditions of all capital elements would lead to a confusing abundance of information which would tend more to mask the essential than to increase transparency. Furthermore, in many cases it is competition-sensitive information, the disclosure of which could also be misunderstood as a public offer within the meaning of prospectus regulations. Against this background, we point out that substantial prospectus law issues could arise from this for the institutions, with a scope and effects which we are unable to estimate at present. In addition, there is the risk that the disclosure of terms and conditions will clash with agreements under private law, or in other words conflict with agreed terms. We consider the resulting legal questions to be neither necessary nor desirable. In view of this, we expressly reject the disclosure of the terms and conditions of all capital components.

2. Risk Coverage

Points (110 - 201)

General Comments on the "Risk coverage" Section

In general we understand the aspiration for monitoring and for taking a close look at the existing regulations of capital adequacy requirements of counterparty risks in light of the experiences resulting from the recent financial market crisis. The motivation for revising the existing rules is apparent and the published consultative document makes clear the fundamental objectives of the Basel Committee on Banking Supervision. Some passages of the consultative document focusing on "risk coverage", however, do not yet fit in consistently with the overall regulatory picture at the present time. In addition, some conclusions and recommendations on implementation seem unclear and worthy of discussion. Lastly, the contents of selected sections need to be described in further detail.

The proposed new regulations surprisingly differ little based on the degree of progressiveness of the internal risk models that are used. We are critical of such a development in the direction of standard regulatory approaches to the disadvantage of internal models. Especially in light of the experiences gained during the financial market crisis, supervisory incentives should be selected for continuously further developing the internal risk model in terms of a best possible risk model infrastructure, efficiency and even diversity.

Moreover, we critically view that a majority of the recommendations increase the risk-weighted assets (RWA) of the banks which are currently using their own internal models. By doing so, the economic incentive for drawing up internal models is significantly reduced. The situation is further aggravated by the fact that institutions with an internal model approach should apply supervisory parameters that are counterproductive to a suitable internal control. We fear that internal models will wither away and thus become regulatory "model concepts". A synchronization between bank-internal models and the

dimensioning of regulatory capital requirements must be safeguarded. That is also urgently called for in light of the fulfillment of the Use Test requirements.

Specific Comments

Counterparty Credit Risk (CCR) – Revised metric to better address CCR

Points 118 - 122

The calibration of models on the basis of the Basel requirements seems rather artificial. The results of calculations are not economically reasonable regarding assumptions on stressed model parameters and are thus not suited for internal control. In addition, the desired stress EPE calculation produces a significant expenditure in terms of developing models and calibration. Besides an economic exposure calculation that is particularly relevant to the daily limit monitoring, there are two other (stress) EPE calculations that are primarily motivated in terms of bank supervision to be taken into account. We take a critical view of the resulting additional expenditure and the fact that the internal calculation processes and bank supervisory processes run in different directions.

The concept of the stress EPE calculation moreover raises questions as to implementation. For instance, it remains to be seen how drift or mean revision parameters are to be taken into consideration in such an approach. Furthermore, EPE models typically base on forward curves. Even here the consultative document does not specify whether the current forward curve is to be used or there is an entitlement to make use of historical data as well. We have the impression that the recommendations involving the stress EPE assume that all models are based on historical volatility and correlation estimates. That is not the case however. We kindly ask for clarification of these issues.

The causal link between the General Wrong Way Risk and an Effective EPE based on stressed historical market parameters is unclear and needs to be explained. While both effects result in an increase in the counterparty exposure, the argumentation in favor of "Stressed Effective EPE" is blurred here. In addition, there is a lack of clear delimitation regarding the regulatory Alpha factor, which is to be adhered to in the future as well. The Alpha factor is already used to take into account the General Wrong Way Risks and its scope has been regarded as sufficiently conservative in the past at least.

The definition of the stress period that must be applied as the basis for calculating the "Stressed Effective EPE" is noticeably vague. Further details in this regard would be desirable. Moreover, the proposal to focus on the maximum RWA based on the Effective EPE and the RWA based on the "Stressed Effective EPE" on the level of the counterparty portfolio seems questionable. Such an approach on the counterparty portfolio

level is hard to implement, since it inevitably results in scenario inconsistencies. In a balanced bank portfolio, the exposure increases and decreases cancel each other out partially in the case of a changed market situation. The recommended maximum rule does not reflect this exposure behavior of a bank portfolio. Instead, securitization with regulatory capital would be geared at least partially to risk scenarios that by definition could never occur simultaneously.

It is also unclear at present when and how the mentioned stress periods must be changed. Any change to the underlying stress period would presumably have difficult-to-predict exposure leaps and thus cause RWA leaps as well.

Institutions which have positions from stock market derivatives in their capacity as a clearing member of a stock exchange or clearinghouse vis-à-vis a customer, are in a particular situation with regard to the counterparty default risk. These specific positions (formally OTC positions) have a generally different quality compared to normal OTC positions and therefore must receive in our opinion special treatment when taking the stressed VaR results into consideration: The stress periods should also be taken into account for calibrating the model parameters (volatilities, correlations) for calculating the EEPE/EAD [Points 120-122]. Specifically, the influential EEPE should be calculated as the maximum from (i) the EEPE based on current market data and (ii) the EEPE based on parameter calibration over a three-year period, which encompasses precisely the stress period that is also used for the Stressed VaR as part of the new requirements for internal market risk models. This parameter does not take into account that the clearing conditions for stock market derivatives usually envisage a quick, possibly same-day, increase in the collateral securities to be provided (initial margins). Although a volatility increase as a result of the market crisis, as it should be depicted by taking into account the parameters based on the Stressed VaR, may lead to an effective exposure increase in case of netting sets from OTC derivatives, it is always neutralized by an adjustment of the security requirements/initial margins by the clearing house or by the institution acting as clearing member with netting sets from the stock market derivatives. A clearing bank can in particular demand increased collateral without a collateral increase on the part of the clearing house vis-à-vis its customer.

To take this mechanism into account, we suggest the following changes (amendments in bold print):

In Point 122, pertaining to the redrafting of paragraphs 25(i) of Annex 4, after the last sentence: "Banks must use the maximum of the portfolio-level capital charge based on Effective EPE using current market data and the portfolio-level capital charge based on Effective EPE using the three year period that includes the one year stressed period that is used for the Stressed VaR calculation in the updates trading book rules for market risk. **If due to risen volatilities a bank can unilaterally increase the collateral requirement against its counterparties and can legally enforce such an requirement, the bank is allowed to**

consider such increased collaterals in calculating the Effective EPE based on Stressed VaR calculations."

In Point 156, pertaining to the new version of paragraphs 41(iii) of Annex 4, after the last sentence:

"Banks using the internal models method must not capture the effect on EAD of any clause in a collateral agreement that requires receipt of collateral when counterparty credit quality deteriorates. **Banks may capture the effect on EAD of clauses that allow unilateral requests for increases in the collaterals due to risen market volatilities if such requests can legally be enforced."**

Bond-equivalent of the counterparty exposure to capture CVA losses

Points 123 - 125

The scope of these guidelines is not very clear in our point of view. We kindly ask for clarification as to which institutions should be affected by this scope. Based upon our understanding, the requirements do not affect institutions which both apply the standard credit risk approach but waive the internal model for the purpose of the trading book.

The proposed method, which is based on bond equivalents, seems very general and as a result provides an approximate picture of the CVA change risk in any case. Even the additional spread-dependent capital backing encourages to a large extent, contrary to the actually desired mitigation of procyclical effects, an increased capital backing especially in times of crisis. Moreover, the term of the synthetic loans is defined extremely conservatively as the longest effective term of all netting agreements of a counterparty. Let's assume that two netting agreements were entered into with one counterparty: (1) one netting agreement with fewer long-term transactions and (2) one netting agreement with many short-term transactions. In such a case, the current proposal would significantly overestimate the CVA change risk.

Moreover, it would be very positive if besides the Plain Vanilla Single Name CDS, the CDS indices and specific securitisations were taken into account with the Value at Risk calculation, since a considerable part of the counterparty risk portfolio is safeguarded by the latter.

The derivatives business in the small business sector in particular depends on such risk transfer instruments, as there are no Single Name CDS for such customers.

The banks that possess an internal model which is approved by a supervisory body for calculating CVA should be permitted to apply this model as well for the purpose of the CVA change risk calculation. Not only would more advanced calculation models be implemented in comparison to the bond equivalent model: Banks that have a certified internal model could also maintain a consistency between a CVA

calculation and a CVA change risk calculation. We are generally in favor of an option to use a bank's own internal model, whose risk adequacy can be verified by means of CVA Value-at-Risk backtesting.

We moreover do not comprehend the reasons as to why a one-year holding period is required. This requirement is disproportionately conservative and conceptionally unsubstantiated compared to the other market price risks. The CVA risk that is to be documented is not in the classical sense a default risk but rather a risk arising in connection with the change in market parameters. The method of calculation seems to us so conservative that the CVA change risk is covered sufficiently due to the supervisory requirements on the general market risk for calculating the regulatory capital based on the sum of the VaR and Stress VaR and for ignoring diversifications with other market risk positions. That's why the existing holding period should not be extended.

Points 126 - 131

The proposed approach for treating particular correlation risks provides initial interesting and pragmatic models for risk identification and an initial risk monitoring. Nonetheless, we believe that it is too general and undifferentiated for a suitable calculation of the regulatory capital here.

The discussion is, moreover, about "explicit legal relationships" and/or "legal connections" between the Counterparty and Underlying. To avoid any misunderstandings, a detailed definition of these terms would be very welcome.

In addition to that, credit derivatives are treated unfavorably compared to share derivatives insofar as the entire relevant nominal should be applied as Exposure at Default (EAD). It would be completely appropriate to introduce conservative recovery estimates as an alternative to this blanket 0 % recovery assumption.

After all, the question of how to treat Total Return Swaps and CDS Index transactions in general remains open.

Multiplier for the asset value correlation for large financial institutions

Points 135 - 140

We object to the significant, approx. 30 % increase that is planned for capital requirements for default risk exposures vis-à-vis banks and insurance companies with a balance sheet total exceeding US$ 25 billion by modifying the IRBA risk weight function for this sector. We are currently unable to understand the planned increase in asset value correlation by the factor 1.25. Since the IRBA function was derived from an one-factor model, the asset value correlation is the only parameter that can be changed in this function to cause

an increase in the regulatory capital requirements. We are not able to approve the proposed adaptation of the function without sufficient analysis of the correlation between "financial firms", which would justify the use of the 1.25 plus factor. Studies recently published with regard to this subject (e.g. Kalkbrenner, M. and Onwunta, A.: Validating structural credit portfolio models. In Model Risk - Challenges und Solution for Financial Risk Models, Risk Books, 2010) point to the converse.

In Point 140 of the consultative document, the Basel Committee also requests remarks regarding the general level of asset value correlation. In this context, we suggest recalibrating the asset value correlations of the other exposure classes consistently by means of a general backtesting. Here there are clear indications that the contribution the classical lending business makes to system risk is far less than previously assumed (and calibrated in the Basel framework). The crisis as stress scenario has illustrated strikingly that the granular retail business and midcap business in general, and the European financing structures in particular, have had great stability. Previous empirical studies on the extent of the asset value correlations correspondingly show for corporate and retail exposure classes an overestimation of the asset value correlation of approx. 50 % compared to the effective regulatory specifications. This fact is generally recognized, Basel II has set itself the goal to keep the capital quota in the system constant. That was achieved by a disproportionately conservative calibration of asset value correlations. This rationale does not apply, however, with the extended risk coverage and increased requirements on the quality of the capital. In addition, it seems hardly reasonable that the asset value correlations for interbank claims are adapted on the basis of experience from the financial crisis without conducting a corresponding recalibration for the remaining exposure classes as well.

We suggest performing a recalibration of the asset correlation factors by the regulatory authority within the framework of evaluating the QIS across all exposure classes.

140. The ZKA suggests the following definition for unregulated participants on the financial markets:

Unregulated financial market participants are companies that, without regard to the legal form, acquire and sell financial instruments on a commercial scale and are not subject to any particular financial supervision by national authorities.

Collateralised counterparties and margin period of risk

Points 141 - 149

We are very critical of the suggestions made in this section. These are certainly important aspects that must be taken into consideration as part of the risk management framework. Nonetheless, we believe that it is an exaggeration to state that conservative assumptions should be made with regard to all aspects of the models.

We believe that the notion that the capital requirements should be determined on the basis of these accumulated worst-case observations is in particular excessive. Here one should note that multiple factors have already been implemented in the IMM concept for general model uncertainties (e.g. application of the Alpha factor and use of the Effective EPE as non-decreasing exposure function). In this respect, the cited aspects should be included as a requirement in a stress test concept but have no direct effect over the capital.

Points 150 – 153

While the reasoning behind the suggestions is apparent here, the rules do not yet seem fully developed. For instance, it is unclear why the number of transactions should be decisive for determining the risk horizon. One large volume transaction can be subject to far greater risks than 5000 very small transactions. Besides the arbitrary differentiation with 5000 transactions, the assumption that large portfolios result more frequently in disputes with the contractual partners seems questionable. Disagreements can more likely be attributed to the nature of the transactions than the number of transactions. Focusing mainly on the number of transactions leaves the impression that the operational risks are at issue and not the counterparty risks. The seemingly arbitrary limit based on 5000 transactions could also provide incentive for handling many transactions under one collateralization agreement such that the increased risk horizons are not implemented. In addition, the possibility that this limit could be exceeded or undershot repeatedly would lead to unwanted leaps in exposure calculations and RWA calculations.

Finally, the "hard-to-replace" derivative criterion is not worded clearly. In other words, the term leaves too much room for interpretation or uncertainty.

Institutions which have positions from stock market derivatives in their capacity as a clearing member of a stock exchange or clearing house vis-à-vis a customer, are in a particular situation with regard to the counterparty default risk. These specific positions (formally OTC positions) have a generally different quality compared to normal OTC positions and therefore must receive in our opinion special treatment when taking the stressed VaR results into considerations:

- Stock market derivatives have a considerably higher liquidity due to the supply and demand aggregation on a stock market as a central marketplace especially in critical market situations.
- Clear market prices, which are publicly available and can be retrieved in an automated fashion using the infrastructure of the stock exchanges and data providers, are always available for stock market derivatives due to their standardization and clear ticker symbols. The complicated coordination process which involves the mutual communication of expected prices and possibly the effort to obtain independent prices during the closing of positions from the OTC derivatives and which frequently lasts many days is no longer applicable here.

- In addition, stock market derivatives are always Plain Vanilla products that permit a simple and fast handling in all IT-intensive processes for risk calculation, settlement, position coordination, etc. and which result in a considerably lower operational risk than in the case of complex OTC derivatives.
- The conditions of participation for clearing houses envisage extensive and highly automated collateral or margin systems. Here it is possible to react to market distortions or the insolvency of market participants quickly, possibly within a given day, by way of ad-hoc adjustments to margin parameters, intraday margin calls and clearing of positions in case of non-fulfillment of margin requirements. Clearing banks are also responsible for these mechanisms vis-à-vis their customers.

These key differences to "normal" OTC derivatives do not justify an imputed margin period of risk of five, ten or even twenty days as is called for in the consultative document [points 150 ff.]. The central counterparties themselves usually anticipate a margin period of risk of one or two trading days and calculate their initial margins based on this period. These imputed margin periods of risk have stood the test of several decades.

A lack of preferential treatment of stock market derivatives, which is necessary due to the significant differences, would have more unwanted consequences:

- The objective of the Basel Committee to shift more derivative transactions to stock markets and CCPs by means of regulatory incentives would be blocked.
- The growing market of commodity derivatives, which are used primarily by industrial companies and public utilities and less by banks, would also be at a disadvantage. Higher capital requirments by clearing banks for stock market commodity derivatives will result either in more fees and charges for industrial companies or will transfer market shares from stock exchanges/CCPs to the OTC market.

These arguments justify in our opinion a preferential treatment of these stock market derivatives of institutions even in the relation between clearing members and non-clearing members. The planned restrictions at least should not be implemented here. That's why we propose the following change (amendments in bold print):

In Point 153, pertaining to the redrafting of paragraphs 41(i) of Annex 4of the Basel II Accord, first sentence:

“For transactions subject to daily re-margining and mark-to-market valuation, **which are not exchange-traded contracts**, a supervisory floor of five business days … of modeling EAD with margin agreements. **For all netting sets containing only transactions which are listed at an exchange and which are**

cleared via a recognized CCP, the supervisory floor for the margin period of risk is equal to the period that the CCP applies for calculating initial margin requirements."

Central Counterparties

We are in favor of keeping the assessment basis of zero for the counterparty default risk for derivatives that have been cleared by a central counterparty (CCP) as part of calculating the capital requirements. Here we would like to point out once again that not all derivatives are suited for a CCP clearing.

To avoid any distortion of competition, the requirements on CCPs must be established in an internationally uniform manner in order to achieve a zero weighting of derivatives. For that reason, we welcome the initiative cited in Point 166 of the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) to establish high quality requirements for CCPs. We would like to point out as a precautionary measure that the banking industry cannot be held responsible for checking whether and which CCPs comply with the standards. In this respect, a corresponding list should be published by the regulatory authorities.

There are at the same time reservations that strict requirements on CCPs could result in high "costs of use": in the form of higher margin requirements, for instance. The additional costs arising as a result of this interdependency calls for closer examination. The "price of security" should not exceed the potential savings from the utilization of CCPs.

Finally, the aim to exclude exposure of default and/or guarantee funds with CCPs from the assessment basis of zero is incomprehensible. The motivation for such a differentiation based on types of exposure is unclear and should be revised or explained. Such "clearing funds" are only very rarely used as the last stage of the "layers of defense" in clearing houses (e.g. the sixth stage at Eurex Clearing). As far as we know, the large European clearing houses Eurex Clearing, LCH, ECC and ICE Clear have never touched the clearing funds, even during the bankruptcy of Lehman Brothers in particular. The envisaged or announced stricter regulations for CCPs will tend to have less and less impact on the probability of the availment of clearing funds. In this respect, the parallel measure that is envisaged for having to take into account or back contributions to clearing funds in the future seems strange [Point 166]. The measure is moreover contrary to the declared objective of the Basel Committee to allow for processing more derivative trading via central counterparties.

The requirements on the imputation or capital backing for contributions made to clearing funds with central counterparties should at least consider the extremely low likelihood that a clearing fund ever has to be utilized or the even lower probability that a complete availment ever occurs.

That's why we propose the following change (amendments in bold print):

In Point 166, to be inserted after the next to last sentence: “The Committee will consider establishing simple risk weights for the exposure arising from guarantee fund contributions. **The very low probability for claims on guarantee funds due to defaulted clearing banks will be considered.** Equity investments in CCPs **…**”

Enhanced CCR risk management requirements

Points 171 - 176

Implementing the proposed guideline changes requires the availability of extremely long data histories and would generate tremendous expenditures in terms of implementation. Stress testing also includes in particular the reverse stress testing for pointing out a number of different scenarios and the simultaneous stresses resulting from exposure and financial standing of a counterparty.

A backtesting of a given period of time that is greater than one year has minimal validity if you consider that a measurable sample can only be obtained less than once a year. A specific minimum number of samples are required to be able to draw any sound statistical conclusions and to prevent any erratic backtesting results. For that reason, we suggest limiting the backtesting to a maximum forecast period of one year.

In regard to validating the distribution of forecasts, we are of the opinion that specific recommendations which may have the character of requirements should not be made, for instance, with respect to validation of certain quantiles. Rather, institutions should have the freedom to choose methods with regard to validation. The respective methods are subject to an examination by supervisors.

Addressing reliance on external credit ratings and minimising cliff effects

Point 191: We welcome the proposed revision of paragraph 99 that envisages using a low-quality rating only for unrated claims if these are on the same level as or are subordinate to the low-quality rating.

Point 194: We consider the need that an institution must take a critical look at external ratings as understandable. We would like to point out though that this requirement should not result in obliging an institution to create a "shadow rating". It is important to remember that external ratings also contribute to

making the movement of capital efficient, since it is not possible for an individual institution to conduct its own research with regard to an issuer's bond that is available on the market. In our opinion, the major rating agencies still have access to internal information about a customer (corporate strategy, audit reports, information regarding research and development) which institutions do not always have at their disposal during the course of their assessment. Up to now, only the ratings in specific segments (e.g. securitization transactions) have provided grounds for criticism, since the rating agencies have applied their own system, which was developed for evaluating companies and simple bonds, to the assessment of structured products more or less without any changes.

Banks that implement the IRBA must prepare an internal rating system for the majority of the borrowers of their portfolio. For the remaining variable it is usually difficult to perform a risk assessment that complies with the requirements on an internal rating system. Banks that utilize the standardized approach have to make sure that their own information is included in the assessment when gauging the suitability of capital resources. Doing so ensures that such banks do not rely solely on a rating prepared by a third party. Checking the appropriateness of the rating and risk weighting for all exposures runs counter to the principle of proportionality inherent in pillar 2 and results in a significant additional expenditure. In light of this, we object to the proposed revision of paragraph 733.

Point 196: We welcome the objective to take into consideration the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies as part of the recognition process of rating agencies.

Point 199: We also take a positive view of eliminating the A rating that was required in the past for guarantors in the standardized approach and FIRB approach.

3. Leverage Ratio

Points 202 - 238

General remarks

- Unsuitability as capital ratio

The ZKA rejects the concept of the leverage ratio. Introducing a leverage ratio to supplement the risk-sensitive Basel II framework would not, in our view, be a coherent approach. This is because, unlike the Basel capital requirements, the leverage ratio does not set a prudentially recognised measure of the risk of economic loss (sum of risk-weighted assets) against a measure of loss coverage (regulatory capital).

- Lack of risk sensitivity and incentives to increase the riskiness of business models

A nominal consideration of assets is even less sophisticated than the old Basel I approach and makes no distinction between investments carrying little risk and those carrying high risks. A triple A investment "uses" the same amount of capital as does a position rated sub-investment grade. This creates an incentive to do business which, while "using up" the same amount of Tier 1 capital, promises a higher return and is thus riskier. If the leverage ratio has a limiting effect, this focus on a capital ratio in conjunction with a nominal consideration of assets therefore results in a comparative preference for high-risk transactions. Yet ignoring a transaction's inherent risks cannot possibly be deemed a useful approach.

The leverage ratio is consequently not only an unsuitable instrument for a bank's internal capital management, but may also be at odds with this management. At the very least, the complexity of capital management will be increased unnecessarily.

- Conflict with Basel II – overriding of Basel II

Though the Basel Committee intends the leverage ratio to operate alongside the risk-based Basel II rules as a stringent supplemental restriction on banks' activities, it will never actually be able to fulfil this function. Depending on where the maximum leverage ratio is set, this supplemental measure will either be ineffective or override the risk-based Basel II capital standards. In the former case, the leverage ratio would be superfluous, so it may be assumed that it will set at a level which will prove a constraint at least temporarily on certain banks. In the latter, more realistic case, the risk-based rules will no longer be relevant, the leverage restriction will be a stand-alone measure and, as an indirect consequence, the risk-based capital requirements will also have to be adjusted upwards. The weaknesses mentioned above will show their effects.

Particular problems are likely to arise if the leverage ratio has a more limiting effect than do capital requirements. The capacity to lend to the economy would be further restricted. In our view, the leverage ratio should at most be introduced in Pillar 2 as a monitoring tool in the context of the supervisory review process. National supervisors could then monitor the leverage ratio, enter into dialogue with any bank exceeding a pre-defined threshold and take suitable steps if warranted by the actual risk situation (cf. outlier principle). The role played by a bank's business model is discussed below.

- Disadvantages for certain business models – structural policy

Banks with different business models (e.g. development banks, mortgage banks, private bankers or guarantor banks) normally also have different refinancing structures. If deposit taking is a major business segment, this usually results in a comparatively high leverage ratio. Different abilities to access markets for

external capital funding also normally result in different equity ratios. Banks which engage in low-risk business, such as state-financing banks (e.g. development or Pfandbrief banks) and traditional European retail banks, are at a disadvantage as well. This problem affects not only specialist banks, but also universal banks operating in the same business segments. The leverage ratio should not make it impossible for these low-risk business models to function, especially in view of the fact that they proved their worth during the recent financial crisis. This means that in the future banks of this kind should still be able to earn their cost of capital on the basis of adequate, risk-based rules on capital backing .

Owing to their business modell, especially on financing residential and commercial properties and public-sector loans, Pfandbrief banks have comparatively high total assets. The introduction of a leverage ratio as a binding regulatory restriction would therefore hit Pfandbrief banks particularly hard because of the extensive number of assets with a low risk-weighting in their cover pools. Development banks would be similarly affected because they hold a large number of state-guaranteed financial instruments, whose low level of risk under the Basel II capital regime is insufficiently reflected by the leverage ratio. Depending on where exactly the leverage ceiling was set, there would be a huge impact on lending practices in the area of public-sector loans and possibly on the entire business model. A further problem is that the requirements of the German Pfandbrief Act are not compatible with those of a leverage ratio. Unlike other banks, Pfandbrief banks have to keep the loans used as collateral for Pfandbriefe on their balance sheet. The coverage of Pfandbriefe in circulation must be ensured at all times. It is therefore only possible for a Pfandbrief bank to shrink its balance sheet – a move which the introduction of a leverage ratio may make necessary – if a Pfandbrief matures and is not replaced with a new issue. Owing to the normally long Pfandbrief maturities of between five and ten years, the introduction of a leverage ratio would pose major problems for Pfandbrief banks.

We would like to draw attention in this context to the importance of Pfandbriefe to the German economy. According to statistics for 2009, 82% of the loans underlying Mortgage Pfandbriefe are secured by residential and commercial property in Germany. Small and medium-sized enterprises in Germany traditionally secure their loans with property. As at 31 December 2009, 79% of the loans used to secure Public Pfandbriefe were loans to German public authorities. With tax revenue falling, state-financing banks are becoming an increasingly important source of funding for German public authorities at all levels.

Development banks would be similarly hard hit. They engage in competitively neutral, low-risk business. This business model proved its worth in the financial crisis. The services supplied by development banks helped to cushion the downturn and are now providing vital impetus for the recovery of the German economy. Development banks would be severely penalised by the introduction of a leverage ratio.

Then there are retail banks, which focus on comparatively low-risk lending on the asset side (e.g. private housing finance) and on deposit-taking on the liability side. One possible reaction to the leverage ratio by

banks would be to compensate for a deleveraged asset side of the balance sheet by cutting back on retail deposits. This would totally fly in the face of the Committee's objective of enhancing the stability of the financial system. Retail banks would also be severely penalised by the introduction of a leverage ratio.

Institutions which exercise a central banking function for a network of banks would also be placed at an unwarranted disadvantage. The process of transferring liquidity within the network inevitably results in an increase in assets and liabilities vis-à-vis affiliated banks (through an expansion of the balance sheet) and thus to a comparatively high leverage ratio.

A single maximum leverage ratio imposed on banks with widely diverging business models would always be too high or too low for the individual institution. One ratio for all banks irrespective of their business model could never take adequate account of different business models' special features. Certain business models will therefore always benefit while others are penalised, regardless of the actual risk situation. The leverage ratio thus has the potential to impact radically on the international banking structure and influence structural policy. This distortion of competition is inherent in the concept of a leverage ratio and cannot be rectified by applying a range of different ratios. We firmly reject the idea of conducting structural policy by means of regulatory requirements, which should be strictly neutral towards business models. Even in the form of a ratio for monitoring purposes only, there is a danger for the reasons outlined above of the leverage ratio seriously limiting the comparability of banks at national and international level.

- Competitive distortions caused by accounting standards

The accounting standards that a bank applies have a significant effect on the level of its leverage ratio. Banks engaging in exactly the same business activities will have widely differing leverage ratios depending on whether they use US GAAP, IFRS or national standards (e.g. the German Commercial Code). Though the Basel Committee proposes eliminating differences in netting for the purposes of calculating the ratio, this would remove only one reason for the disparity. The work by the FASB and IASB on convergence issues well illustrates that questions such as hedge accounting, consolidation, impairment and the definition of equity are not treated under the two sets of standards in a sufficiently comparable way. The level of equity and size of exposures – both on and off the balance sheet – are therefore determined by a number of further differences arising from differing understanding of recognition and measurement. Since the level of accounting equity is a residual amount, it inevitably depends on the permitted methods or recognising and measuring assets and liabilities.

An internationally uniform leverage ratio would consequently generate considerable competitive distortion. This distortion could only be avoided by convergence between accounting standards (especially IFRS and US GAAP). It is open to question, in our view, whether absolute convergence is really feasible, yet we regard it as an absolute prerequisite, particularly when it comes to the disclosure of the leverage ratio for the

purposes of making international comparisons. We therefore urge against requiring disclosure of this ratio under Pillar 3.

- Interplay with the proposed liquidity requirements

We would like to draw attention to the interplay with the liquidity requirements proposed in the Basel Committee's consultative document *International Framework for Liquidity, Risk Measurement, Standards and Monitoring*. The proposed limitation of the definition of high-quality liquid assets to government bonds would mean that meeting liquidity requirements would largely "use up" the amount of assets a bank could hold while still complying with the leverage ratio. If these low-risk investments already accounted for a large part of the potential business activities permitted under the leverage ratio, this would restrict banks' lending capacities in an unintended way. We therefore firmly believe that the reserve of high-quality liquid assets which banks will be required to maintain should be excluded for the purposes of calculating the leverage ratio. Furthermore, we call on the Basel Committee to carefully examine this aspect in the context of the quantitative impact study.

Specific comments

Points 202 and 204

Par. 202 points out that the banking industry was forced by the market to reduce its leverage during the financial crisis. A regulatory leverage ratio may at some stage face a similar response as did the risk-sensitive Basel II rules. Investors and credit rating agencies may come to the conclusion that the rules regulating the ratio are too lax or that the ratio provides insufficient meaningful information and demand stricter constraints on leverage. Hence the introduction of a maximum permitted leverage ratio will not necessarily prevent the undesirable effects of externally imposed "destabilising deleveraging processes". This argument for restricting leverage is therefore flawed, in our view.

Point 204 goes on to state that a leverage ratio would "reinforce the risk-based requirements". The Basel Committee has already eliminated, or is planning to eliminate, various weaknesses and understatements of risk revealed during the crisis by tightening and reforming the risk-based Basel requirements in areas such as market risk modelling and securitisation. We are convinced that this is the right way forward. The amendments to Basel II in these areas will make the understatement of risk by internal models increasingly unlikely in future. Review of the risk-based Basel II requirements is therefore preferable to the introduction of a restriction on leverage.

Point 208

The only appropriate measure of capital in our opinion is Tier 1 in its entirety without any deductions, since all elements of Tier 1 fulfil the functions of going concern capital. Furthermore, the leverage ratio aims at limiting the level of debt capital.

Setting an internationally uniform minimum equity ratio would therefore give rise to significant competitive distortion. This distortion could only be avoided by large-scale convergence of accounting standards, especially IFRS and US GAAP, but also national standards. Convergence of this kind will not be achieved in the foreseeable future, yet we consider it an absolute sine qua non for the introduction of a leverage ratio.

Point 218 and 219

So-called “cash-like instruments” are to be included in full in the baseline proposal while the alternative option permits zero weighting. In view of the interplay with the planned liquidity regime, we consider it essential that zero weighting is always assigned to these instruments. It is likely that the envisaged liquidity buffer will be built up not only through an exchange of assets but also, at least in part, by expanding the balance sheet. To avoid these parallel liquidity requirements, especially for the liquidity coverage ratio (LCR), placing additional strain on the leverage ratio, these must be adequately taken into account – particularly given that cash-like instruments are assets whose eligibility as high-quality liquid assets is not in doubt.

We strongly advocate consistency between the definition of “cash-like instruments” for the purposes of calculating the leverage ratio and the definition of “high-quality liquid assets” in the planned liquidity regime. Diverging definitions would generate a substantial administrative burden without providing any regulatory benefit.

The requirements proposed in the Basel Committee’s consultative document *International Framework for Liquidity, Risk Measurement, Standards and Monitoring* envisage that banks should have to hold high-quality liquid assets to satisfy the LCR. If these low-risk investments already account for a large part of the potential business activities permitted under the leverage ratio, this will restrict banks’ lending capacities in an unintended way. We therefore call on the Basel Committee to carefully examine this aspect in the context of the quantitative impact study. The analysis should also cover central bank eligible securities which, while not qualifying for the LCR, are nevertheless able to generate liquidity if necessary.

Point 225

The Basel Committee is considering an alternative approach to securitisations which would diverge from their accounting treatment. At issue is whether an originator bank should, when calculating its leverage ratio, include assets which it may feel obliged to take back onto the balance sheet at a later date. An asset

cannot be derecognised until it has undergone a thorough testing process. We are therefore in favour of retaining the accounting approach.

Point 227

Derivatives are valued at regular intervals for both accounting and operational purposes. They are measured not at the nominal value of the underlying transaction, but at their current market value. This is also the relevant value if a derivative contract has to be unwound before maturity or sold. At first glance, therefore, option (ii) would appear the most logical. However, the proposal mixes an accounting perspective with predictions of future developments without taking account of contractually agreed risk mitigating instruments such as margin calls. We therefore reject the idea of including potential future derivatives exposure in the calculation of the leverage ratio.

Point 231

Written credit protection is to be included in the measurement of assets at its full nominal value. Netting with bought credit protection will not be permitted. This requirement will damage the CDS market because market making costs will become prohibitively high although the vast majority of written credit protection positions are hedged with bought credit protection. Written credit protection should therefore be included in the leverage ratio calculation only after netting with bought credit protection.

Point 233

A credit conversion factor of 100% is proposed for the inclusion of all off-balance-sheet items in order to prevent excessive leverage. This assumes that all off-balance-sheet positions will actually be drawn on up to the agreed limit. No distinction is made between these items and loans, which is not logical from a risk angle. This will affect, among other things, trade finance products such as letters of credit, which (i) cannot generate excessive leverage because of their link to underlying customer transactions and (ii) are rarely drawn on in practice. Since the leverage ratio is intended to supplement Pillar 1’s risk-weighted ratios, we recommend that the conversion factors deemed appropriate by the Committee for the purposes of calculating capital requirements should also be used for leverage ratio calculations.

4. Procyclicality

Points 239 - 262

General remarks

We support the Basel Committee's intention to analyse the procyclical effects of Basel II and, if necessary, take targeted measures to reduce this procyclicality.

Given the comparative lack of detail the consultative document provides about the proposed measures, we assume that the Committee intends to first evaluate in depth the impact of all four packages of proposals. This is essential, in our view, especially since certain relevant aspects have yet to be clarified (e.g. IASB proposal for revising the incurred loss model in IAS 39) and other measures are not covered by the quantitative impact study (e.g. fixed and flexible capital buffers). For the time being, therefore, our evaluation of the various proposals can focus only on their broad thrust. We strongly support the quantitative impact study, since we hope it will shed more light on the effects of the planned regulatory measures.

Since the reduction of procyclicality would have complex macroeconomic effects on the real economy, we recommend implementing only those measures which are likely to prove the most accurate and effective. This applies particularly in view of the fact that the existing Basel framework already contains a number of measures aimed at mitigating potential procyclicality, such as the reduction of cyclical fluctuations of certain risk parameters (downturn LGD) or the special risk weights for exposures to small and medium-sized enterprises. We would ask the Basel Committee to examine whether, in addition to taking new steps to reduce procyclical effects, these existing measures could also be modified and refined.

All in all, we would firmly reject the idea of implementing all four of the proposals at the same time. This is not least because the effects of some measures (e.g. proposal a and proposal d) would overlap to some extent and thus have a cumulative impact of overstating risk.

Specific comments

a) Cyclicality of the minimum requirement

Point 242

The Committee proposes a mechanism for reducing the volatility of capital requirements to be used by all IRB banks. By changing the method of calculating probabilities of default (PDs), minimum capital requirements would be smoothed over the cycle. As things stand, most banks use combinations of point-in-time (PiT) and through-the-cycle (TtC) ratings to calculate PDs. As we understand it, the Committee is proposing that the PDs in every rating grade should be adjusted by means of a scaling factor. The capital buffer would be calculated as the difference between the capital requirement based on the current PD and that resulting from either a long-term average or a downturn PD. In the first case, the scaling factor would be smaller or greater than 1 depending on the phase of the business cycle. If procyclical effects are to be

mitigated in a recession, we believe it is essential to enable capital buffers to be actually drawn on. Otherwise, there is a risk of a credit crunch.

As we see it, both options represent a fundamental change in the method of calculating probabilities of default and a move away from the frequently used PDs determined on the basis of PiT ratings. Though the use of an average PD might help to reduce procyclicality in both upturns and downturns, it would not, in our view, make good sense to conduct risk management on the basis of an average PD.

We reject any change in the method of calculating PDs for the purpose of determining capital requirements. PiT ratings, which are used by the vast majority of banks for calculating regulatory capital, have many advantages. Only PiT ratings allow problem loans to be identified at an early stage, not least because cyclical deteriorations are reflected directly in companies' annual accounts. As mentioned below in point b), the IFRS rules on provisioning are currently being revised. For these reasons, we would also reject the mandatory application of TtC ratings at risk factor level.

In the second case (downturn PD), the scaling factor would always be greater than 1 except during downturns. The total capital buffer for each exposure class would be the sum of the relevant rating grade. The aim is for capital buffers to increase in size during upswings and decrease during downturns in line with the dynamics of the probabilities of default.

Under this option, the PiT or TtC PDs of an exposure class would be transformed into a recession PD which reflected a stress scenario observed in the past. Banks would consequently always have to satisfy capital requirements appropriate to a recession. In this case at least, the **capital requirements would not dampen cyclicality in any way – they would merely become higher**. On top of this, the use of a downturn PD would distort the risk appropriateness of capital requirements. Banks which used mainly PiT models would have to build up significantly higher buffers while banks that calculated relatively stable PDs with TtC models would hardly have to build up any additional buffers at all. What is more, business with low default risk would be penalised because it would require a relatively high capital buffer to be built up compared to that for transactions of poor credit quality.

Cyclical influences would be reduced under both options, but the result would be highly dependent on the underlying historic period used and the defaults observed there in each individual rating category. And both options would generate internal risk management errors, especially in the monitoring and management of credit risk.

Furthermore, we believe the proposed modification of calculating PDs would widen the divergence between regulatory and economic capital. It would also be incompatible with the eminently sensible Basel use test rules, under which the method used to measure regulatory capital must also be used internally (*International*

Convergence of Capital Measurement and Capital Standards – A Revised Framework, November 2005, par. 444). Yet the convergence of regulatory and internal methods was one of the major objectives of Basel II.

Since asset correlations are specified in the existing framework and apply to both PiT and TtC ratings, the fluctuations of PiT ratings are higher. We would therefore recommend reviewing the asset correlations for PiT ratings.

b) Forward-looking provisioning

Points 243 ff.

This section relates to accounting aspects and points out that the existing rules on accounting for loan impairments are in the process of being revised. The objective of the review is to identify and recognise loan losses at an earlier stage. In the context of a general overhaul of IAS 39 *Financial Instruments: Recognition and Measurement* – now in its second phase – the IASB has issued the exposure draft *Financial Instruments: Amortised Cost and Impairment*. The draft proposes a switch from the current incurred loss model to an expected cash flow model.

The German banking industry is critical of the IASB's expected cash flow approach for a number of reasons. We consider it excessively complex, for example, see few potential benefits and believe it will actually exacerbate procyclicality. These procyclical implications of the expected cash flow model are at odds with the Basel Committee's objective of introducing a less procyclical provisioning model. By contrast, the German banking industry supports an accounting treatment of losses based on an expected loss approach. The strategic and operational shortcomings of the IASB's model should be avoided. One starting point would be to take better account of banks' risk and credit management practices than is the case in the IASB's proposal.

We are in favour of close alignment between provisioning for prudential and provisioning for accounting purposes. In particular, it should be possible to apply models and model parameters used for prudential purposes directly to an accounting impairment model. Otherwise, different systems would have to be established in parallel. The consultation period for this phase of the IAS 39 review runs until the end of June 2010. We would strongly urge the Basel Committee to await the IASB's final version of its new impairment concept before issuing further analysis and proposals relating to this issue.

c) Building buffers through capital conservation

Points 256 ff.

The Committee proposes a rules-based mechanism for building up a fixed capital buffer in excess of minimum capital requirements. Calibration details will follow after the results of the impact study have been published. In the event that a bank's capital requirements are within a certain conservation range above the minimum requirement level, it would be obliged to conserve a certain percentage of its earnings in the subsequent financial year. As we see it, this represents a ban on distributions. If the bank wanted to pay out more than the permitted percentage, it would have to raise sufficient fresh capital to bring it above the threshold triggering the ban.

We reject the idea of a fixed capital buffer for several reasons. What is more, the ban on distributions would constitute massive interference in existing contractual agreements between banks and investors. We have considerable doubts about the legality of such far-reaching interference and therefore strongly urge that measures of this kind should not be applied to existing contracts. We also see a danger of such measures having a seriously adverse effect on the future ability of banks to raise capital, especially if they are in a somewhat precarious situation.

The proposed mechanism would thus hinder a bank's ability to recapitalise. It is consequently at odds with a prerequisite regarded as essential in the context of the future recognition in Europe of hybrid capital components. On the one hand, recognition of certain Tier 1 capital components is explicitly tied to an expectation that these components will not obstruct the bank's recapitalisation. On the other hand, a regulatory requirement is being proposed which would do precisely than – namely make it more difficult for a bank to recapitalise. This is not a useful approach, in our view. For listed banks in particular, the buffer would be tantamount to an add-on to the minimum capital requirement. The introduction of the buffer would therefore have mainly counterproductive consequences for individual banks and the entire financial system.

It should also be borne in mind that banks are normally affected by a crisis to differing degrees. The proposals would place banks that were worse hit at a competitive disadvantage and seriously undermine their ability to "heal themselves". We see a danger that this procyclical impact on ailing banks might have a knock-on effect on other companies and unintended systemic repercussions.

Furthermore, since the ban on distributions would apply at consolidated level, the question arises as to how a constraint on distributable earnings determined at consolidated level should be broken down at solo level. Distributions to shareholders and hybrid investors concern specific legal entities. On top of this, IFRS are not normally used to calculate distributable earnings at solo level. The sum of the annual earnings of individual group entities will therefore usually differ from the group's consolidated earnings. Groups whose scopes of consolidation for accounting and regulatory purposes diverge significantly will face additional problems when attempting to calculate the level of distributable earnings.

If the capital buffer is to have the intended effect of reducing procyclicality, it must be ensured that it can really be drawn on in practice during bad times. Based on the experience of the recent financial crisis, we seriously doubt that this will prove feasible. Since market expectations (e.g. credit rating agencies) would probably prevent the buffer from being used, it would simply become an additional capital charge. This objective could be achieved more easily by raising the minimum capital requirement.

All in all, compliance with and monitoring of rules on the use of earnings would generate a considerable administrative burden.

Another difficulty is that the distribution constraint would need to be complied with on a specific date while a bank's minimum capital requirement may fluctuate over the year. This raises the question of how to comply with the rule in such circumstances.

d) Excessive credit growth

Points 260 ff.

In view of the fact that the Committee will not issue a fleshed out proposal until July 2010, we will comment only briefly on this section of the consultative document. Once the details of the proposed approach have been worked out, a further round of consultation should be undertaken. As we understand it, the Basel Committee intends to require banks to build up an additional, flexible buffer on top of minimum capital requirements. The size of the capital buffer would be determined with the help of one or more macroeconomic variables, with the focus at present first and foremost on credit growth. A ceiling for credit growth would be set in each individual jurisdiction. A breach of this threshold (with credit growth higher than the long-term trend) would trigger an increase in the size of the buffer. The process would be reversed when credit growth dropped below the threshold again.

In principle, we consider a flexible capital buffer organised along these lines preferable to the fixed capital conservation buffer described above. We nevertheless foresee major difficulties in its implementation, even if the Basel Committee does not intend to take a rules-based approach. First, we doubt whether a credit-to-GDP ratio is the right indicator for timely identification of boom and bust phases. In our experience, indicators of this kind always identify booms and recessions with a certain time lag. It would therefore be better to use an early-warning indicator such as a change in CDS spreads. Another problem is that fluctuating capital ratios would make forward-looking capital planning much more difficult.

We would also ask the Committee to address a number of further questions when fleshing out this approach:

- Would the use of the flexible capital buffer be limited to certain regulatory approaches (e.g. standardised approach, IRB approach)?

- Is it possible to draw a clear distinction between normal and excessive credit growth?
- Could the credit-to-GDP ratio take adequate account of regional and sectoral differences?
- How would application of the buffer function across different jurisdictions, especially if some countries were in a boom phase and others in recession?
- Would the capital buffer have to be complied with in recessions as well as booms? How would the shrinking of the buffer function during a recession, especially if the market was unwilling to accept a winding down of capital reserves?

Irrespective of the above questions, our fundamental concern about this proposal is that the introduction of a capital buffer linked to the development of credit growth would constitute massive interference in macroeconomic processes. It could result in differing lending conditions across different jurisdictions and have huge implications for corporate financing. What is more, credit growth does not depend exclusively on the creation of credit by banks. The monetary policy of central banks plays an equally important role. We would ask the Committee to take account of these aspects when giving further consideration to its proposal.