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Possible changes to the Capital Requirements Directive for the trading book and for complex securitisations

Dear Sir or Madam,

we, the Zentraler Kreditausschuss,[1] thank you for the opportunity to comment on the Commission services' consultation paper on possible changes to the CRD related to the trading book and to certain securitisation positions and present the comments of the German banking industry to you in this letter.

Preliminary remarks

The Commission itself explains in the present document that the planned changes to the CRD are "in line with the consultative papers released by the Basel Committee". We welcome this self-imposed requirement of the Commission. However, we urge that the EU implementation not only be compatible with the Basel requirements but that it ensues in EU law on a 1:1 basis. We feel that this is absolutely necessary to ensure an

[1] The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks financial group, and the Verband deutscher Pfandbriefbanken (VdP), for Pfandbrief banks. Collectively, they represent more than 1,900 banks.

international level playing field, which is of immense importance particularly for securitisation and trading book positions.

The requirements of the Commission are based on consultation papers of the Basel Committee. However, the final Basel recommendations have not yet been adopted, so that further changes are indeed still possible and have been requested by the Zentraler Kreditausschuss. Thus, for example, with regard to the trading book proposals, it is expected that the final Basel requirements will not be available before the end of September 2009, if one assumes that the results of the quantitative impact study which will end on May 15th must still be analysed and discussed. Further changes such as the parameter specifications for incremental risk modelling could result. In this connection it is very important that the EU requirements are based on the final version of the Basel rules to prevent divergences between Basel and EU regulations. We therefore urge the Commission to ensure that such divergences be avoided.

Securitisations

General comments

The financial market crisis has made clear the particular risks involved in securitisations. It is therefore appropriate to review the bank supervisory regulations for handling securitisation positions. However, during this process it must be kept in mind that securitisations are a valuable aid to diversification and risk transfer. A general supervisory stigmatisation of these instruments would thus take us in the wrong direction. Rather, the goal of the Commission's proposal must be to prevent previously observed excesses in the future. In our opinion, the proper approach must be based primarily on risk management by the institutions and the evaluation of securitisation exposures by external rating agencies. The institutions have already undertaken enormous efforts to improve the internal processes of risk assessment and risk management in this regard. The qualitative requirements for the risk management of securitisation positions included in the new article 122 a of the Directive 2006/48/EC will further reinforce this development.

We believe that higher capital requirements do not necessarily result in better banking regulation. In the future as well, the capital requirements should appropriately reflect the existing risk. They should be designed so that securitisations can continue to be used by banks for risk management and funding purposes.

To facilitate the conversion to the new regulations for the banks and to avoid pressure to sell in the case of existing securitisation transactions, the new regulations should - in line with the new article 122a of the Directive 2006/48/EC - cover only those transactions issued after 31 December 2010. They should not be applied to existing transactions with replenishment clauses before 1 January 2014.

The proposed disclosure requirements are only suitable to a limited extent to provide an recipient with an understanding of the risk profile of the respective bank. The current abundance of requirements in the directive will, if anything, obscure the important details

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with a information overload, which cannot be what the Commission intended. For this reason, the additional requirements over and above the status quo must be rejected in many cases, especially as much of the information is already disclosed on the basis of the recommendations of the FSF. There is a risk that the group of recipients will receive the same information multiple times (FSF and Pillar 3).

Pillar 3 is intended to complement the minimum regulatory capital requirements (Pillar 1) and supervisory review process (Pillar 2). The disclosure requirements therefore refer primarily to the regulatory assessment of risk within the capital framework. Disclosures relate to figures calculated under Pillar 1 and risk assessment under Pillar 2. It is therefore essential always to be able to provide the required information on the basis of figures calculated for prudential purposes.

If results, data and information are derived from other sources, such as a company's financial statements, this can lead to considerable inconsistencies and also result in users drawing false conclusions. Inconsistencies and overlaps in presentation and content - which are already sometimes a problem under existing rules - must be avoided. To prevent ensuing misunderstandings on the part of users, we suggest that regulatory and accounting disclosure requirements should be closely coordinated between the Commission, the Basel Committee and relevant accounting bodies.

We should also like to stress that banks must be allowed a high degree of flexibility in applying the disclosure requirements so that adequate account may be taken of the individual nature of the institution involved. It would be more useful in our view to outline the objective of the requirements since their precise aim is not always clear. The latter otherwise could lead to misunderstandings regarding what information needs to be provided.

We finally would like to draw your attention to the issue of market perception. We understand that the Commission is currently concentrating on the disclosure for securitisation products, as there is an obvious need for improvement in this area. As set out earlier, we fully support this idea. We feel, however, that finally disproportionally more attentions will be given to the disclosure in relation to securitisation positions than to other issues relating to capital requirements. This might send unintended signals to the market. We therefore kindly ask you to keep this observation in mind in your further work.

Specific comments

Directive 2006/48/EC

Article 4

Under the proposed **definition**, a resecuritisation exposure is already deemed to exist if only one single exposure of the underlying pool can be defined as a securitisation position. For reasons of equality of competition as well as the often varying scope of the

term "resecuritisation position" in the past, we welcome a uniform definition. However, we believe that the proposed definition is much too restrictive. This applies particularly to underlying granular portfolios. Such portfolios often contain small portions of securitisation exposures in order to achieve an optimal risk diversification but these are by no means representative of the risk of the entire securitised portfolio.

Furthermore, the broad scope of application would have a negative impact, particularly on hybrid ABCP conduits, which securitise both ABS and trade receivables. This provision could lead to the splitting up of such programmes and thus increase the pressure to sell on the otherwise securitised ABS, which would further exacerbate the financial turmoil and which also poses the risk of increasing funding costs for SMEs that use such products.

We therefore suggest applying the rules for resecuritisation exposures only to those securitisation exposures whose underlying portfolio consists of more than 25% securitisation exposures as measured by the exposure value.

Furthermore, in our opinion, according to the current definition, certain structured products from ABCP programmes would be inappropriately classified as resecuritisation positions from a risk perspective. In the case of multi-seller securitisation programs, which are widespread in the European market, various acquisition SPVs are refinanced via a central funding SPV. Through the use of multiple acquisition SPVs, various pools of receivables can be acquired and managed separately. Even if an acquisition SPV acquires only unsecuritised exposures, a resecuritisation exposure may exist at the level of the funding SPV according to the present definition. This could occur if, at the level of the acquisition SPV, e.g. via allocation of the cash flow, the criteria for a securitisation are already deemed to be fulfilled, even though the acquisition SPV does not issue any commercial papers or other money market papers which, in our opinion, are necessary for a securitisation to take place.

We do not believe that this is adequate from a risk perspective, as only structural considerations led to the existence of "resecuritisations" in the establishment of ABCP programmes. In addition to economic and practical reasons for the aforementioned ABCP programme structure, there are legal requirements that necessitate the activation of a further SPV (e.g. Italian Law 130 Companies or the French Fonds Commun de Créances, FCC). It is therefore inappropriate to classify such products as resecuritisations. For these structures as well, the securitisation ensues only at the level of the funding SPV, as described above.

Finally, to assess the risk of these transactions, the original underlying exposures are reviewed and the profitability of the transaction linked to its performance, regardless of whether one or more SPVs were activated upstream from the actual funding SPV for practical or legal reasons. We therefore request clarification that such transactions will be excepted from the definition of resecuritisation.

Annex IX Part 3 Nr. 1 item c)

According to the Commission's proposal, a bank is not permitted in future to use any external credit assessment for risk-weighting purposes where the assessment is at least partly based on unfunded support provided by the bank itself.

First, we assume that the Commission intends to apply this rule only to ABCPs purchased by banks who have granted unfunded support for this structure as sponsors. However, according to the current formulation, those cases would also be affected in which an originator has provided unfunded support that influences the rating of retained securitisation positions or of those purchased as part of market maintenance. In this case the proposed rule would mean that the originator would have to treat all retained or repurchased securitisation positions as unrated and, in an extreme case, would have to deduct them from capital.

In addition, we wish to note that the proposals do not make clear what types of supports could result in the ABCP being treated as unrated. It should be avoided in any case that the regulation be applied to all supports of an institution (e.g. standard derivatives or acting as a servicer). It should therefore be made clear that this provision is to be applied only if the bank provides unfunded support which represents a credit enhancement as defined in Article 4, Paragraph 43 of Directive 2006/48/EC.

Furthermore, in our opinion the rating of a commercial paper (CP) should also be recognized even when supported by the banks holding the CP, if via the support the credit risks of the exposures underlying the CP are covered and the credit enhancements are backed with capital. We wish to explain this below using two examples:

a) A credit institution provides a liquidity facility (LF) for an ABCP programme that covers the credit risks of the issued CP. The LF is taken into account in the rating of the CPs. The CPs are given an A-1 rating. At the same time, the institution buys the entire volume of the CPs.

   Under the proposed rule, the institution would not be allowed to use the rating of the CP. As the CRD dictates that the institution probably cannot use any other approach specified in the securitisation framework, the CP would have to be assigned a risk weight of 1250% and/or a capital deduction would follow. The capital requirements for the LF must be calculated according to the relevant rules. A double counting of the same risk is to be prevented by the overlapping rule (Annex IX Part 4 Point 5 Directive 2006/48/EC). Under this rule the position with the higher risk-weighted exposure amount must be backed with capital. The institution would consequently have to deduct the overlapping amount of the LF and CP from capital, which in our opinion would overstate the risk and be completely inappropriate. Furthermore, the inappropriateness of the proposal becomes apparent if the situation mentioned above is compared with a situation where the Bank is not purchasing the CPs and the Conduit draws on the liquidity facility instead. In that case the bank would only have to back the drawn liquidity facility with capital even though it would be exposed to the same risk as if it had purchased the CP.

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We therefore urge that the denial of recognition of the external CP rating be rejected when the supporting instrument (in this case, a liquidity facility) is already backed with capital. The capital requirements for the LF already take into account the risks of the underlying pool and thus also the risks of the CP.

b) Institution A provides a LF_A and Institution B provides a LF_B for an ABCP programme (syndication), whereby LF_A of Institution A covering 50% of the outstanding volume of CPs and LF_B of Institution B covers the other 50%. The CP rating takes into account the LFs of Institution A and B and thus the credit standing of both institutions in addition to the risks of the underlying pool. The CPs is assigned an A-1 rating. Institution A buys all CPs.

   As in the example above, Institution A would probably not be allowed to use the CP rating to calculate the capital requirements. The CPs would thus be assigned a risk weight of 1250%. LF_A would be backed with capital by Institution A according to the relevant rules. Institution B would adequately cover LF_B with capital appropriate to the risks involved. In our opinion, a deduction of the CP from the capital under the given risk conditions would not be justified in this example, either. The risks of the CP are already adequately covered by the capital requirements for LF_A at Institution A and for LF_B at Institution B. As both LFs are backed by capital, provisions for all risks of the underlying exposure in the ABCP programme have already been made. We therefore do not believe that the use of the external credit assessment of the CP for the additional capital backing at Institution A in the amount of the part not covered by LF_A, poses a threat to the stability of the financial market. Without taking the risks adequately into account and with a de facto sanction on the syndication/risk subparticipation in the calculation of capital requirements, the syndication can no longer be used as a risk mitigating tool by an institution; this is to be rejected.

Based on these considerations, from a risk perspective we see no suitable case for application of the proposed regulation and thus urge the deletion of item c).

The proposal for Annex 1 of the Directive 2006/49/EC, point 16a refers banks to the banking book securitisation framework for guidance on calculating the specific risk related to securitisation and resecuritisation positions. As mentioned above, the overlapping rule in Annex IX of the Directive 2006/48/EC, part 4, point 5 prevents the double counting of risks in the banking book. There are no arrangements, by contrast, to avoid the double counting of the same risk in the event that an institution holds the liquidity facility (LF) for an ABCP programme in the banking book and the CPs in the trading book. We would therefore suggest introducing an additional rule along the lines of Annex IX of the Directive 2006/48/EC, part 4, point 5 permitting capital charges for credit risk in the banking book to be set off against those for specific risk in the trading book in the event of two or more overlapping positions in a securitisation.

Annex IX Part 4 Table 1 and 4

The proposal to deduct all resecuritisation positions from capital as a rule is completely unreasonable. Moreover, it contravenes the system of treating securitisation positions as recently specified in the brand-new Article 122 a of Directive 2006/48/EC. According to Article 122 a, Paragraph 3 of Directive 2006/48/EC, investors must carry out extensive due diligence for analyzing the risk characteristics of the securitisation positions. These due diligence requirements do not directly apply to exposures underlying a securitised securitisation position. However, in the obligations with regard to monitoring risk positions in Paragraph 4, it is explicitly specified that for resecuritisations, the exposures underlying securitised securitisation positions must be monitored. In our opinion, those banks that are able to meet the qualitative requirements for due diligence and monitoring of resecuritisation positions should be permitted to apply the risk weights for resecuritisations. If a bank is not able to carry out the required due diligence or monitoring, the sanctions specified in Article 122 a, Paragraph 5 will apply. Accordingly, the corresponding risk weighting for resecuritisations would be multiplied by 250%. In contrast, an outright deduction of resecuritisation positions from capital would not provide any incentive whatsoever for risk analysis. This would run contrary to the goal of the Commission of ensuring proper risk management for securitisations in the banks.

The regulation proposed by the Commission would de facto considerably tighten the due diligence requirements imposed in Article 122 a, Paragraph 3 of Directive 2006/48/EC compared to the just-passed version, which has not even been implemented in national law yet. This would have a negative impact on legal certainty for the banks affected. Furthermore, such a regulation would place EU banks at a competitive disadvantage with other banks.

Moreover, we wish to note that with a proposed broad definition of resecuritisation, the deduction obligation would also apply to products that contain only a small share of securitisations in the underlying portfolio and thus would not necessarily increase the complexity of the overall securitisation structure.

The risk weights in square brackets proposed by the Basel Committee appear to us too high overall, as identical risks are accounted for multiple times. The calibration of the risk weights was apparently carried out based on data from summer 2008. Accordingly, the partially severe downgrades by the credit rating agencies (CRAs) during the past several months were not taken into account. The CRAs have modified their methods, particularly with regard to the evaluation of credit quality of resecuritisation exposures, and now tend to give them significantly poorer ratings. This should also be taken into account in the determination of capital required for these exposures. In our view, the increased risks of resecuritisations have resulted in particular from the delayed rating adjustments by the agencies. It should therefore first be examined whether the present risk weights would be appropriate for the proper, current ratings.

Should, after this review, the Basel Committee conclude that the present risk weights are not appropriate, we suggest multiplying the risk weights of the rating-based approach for securitisations (RBA) by a uniform factor to determine the risk weights for

resecuritisation exposures. The partially considerable rating downgrades for resecuritisation exposures in recent months should be taken into account in determining this factor. We believe that a factor of 1.2 is appropriate.

The granularity of the underlying portfolio could also be taken into account for resecuritisations via the application of a constant factor. The intention of not taking the granularity of the underlying portfolio into account must be rejected harshly. In particular for granular securitisations with a small share of securitised exposures in a securitised portfolio, this would lead to a significant deterioration compared to the status quo, which cannot be justified from a risk standpoint.

We note with satisfaction that the Commission does not wish to implement the drastic increase in the floor risk weight in the SFA from 7% to 20% proposed by the Basel Committee, which can result in the tripling of the previous risk weights. With the Basel proposal, resecuritisation exposures would be doubly disadvantaged, as negative rating migrations for the underlying positions are already taken into account in the system via the increase in K_{IRB}. Furthermore, the increase in the floor would mean that the institutions can no longer use an actually calculated lower risk weight - even after any increase in K_{IRB} - that would be adequate to cover the risk for resecuritisations exposures. In our opinion it is also not clear why the capital requirements for assets with good ratings should be increased far more than for those with poor ratings. However, for reasons of competition we urge that the floor of 7% be multiplied by the aforementioned factor. Furthermore, we assume that the capital deduction for resecuritisations exposures, which the proposal explicitly specifies for the standard approach and the rating-based approach, is not relevant for the SFA. We consider this regulation appropriate and renew our criticism on the intended deduction for the standardised approach and the internal ratings based approach.

We deem the prerequisite for the existence of a senior resecuritisation exposure, namely that none of the underlying exposures is itself a resecuritisation exposure, to be inappropriate. Accordingly, at this point we urge the introduction of a materiality threshold, so that a top-ranked tranche cannot then be treated as a senior tranche if more than 25% of the underlying securitised portfolio, measured by the exposure values, consists of resecuritisation exposures. In our view, even if this threshold value were introduced, the options for circumvention of this regulation would be excluded.

Annex XII Part 1

Point 14

(aa): nature of other risks
We believe that it is sufficient if, when presenting its risk profile, an institution describes the individual types of risk. Furthermore, the relevant risks to which the bank is exposed in the underlying pool are already covered by the disclosure requirements for such non-securitisation risks under Pillars 1 and 2. In addition, the risks to the bank resulting from

its exposures to securitisations are to some extent already disclosed in the description of the roles that it plays. This requirement can therefore be dropped.

<u>(ab): seniority of underlying securitisation positions and assets underlying these latter securitisation positions assumed and retained with resecuritisation activity:</u>
It is not clear to us which information is to be disclosed here. We would therefore welcome clarification of the requirement.

<u>(b): roles played by the credit institution in the securitisation:</u>
We assume this requirement relates to the roles as defined by Pillar 1 rules. Additionally, the bank could also describe any relevant roles it assumes in the transactions it enters into if this information is judged material.

<u>(ca) and (cb): monitoring changes and hedging</u>
These requirements appear to relate to all securitisation exposures and not just resecuritisation. They could be simplified and clarified by spelling out the desired objective. As we understand it, this is to disclose an appropriate amount of information on the bank's risk management and hedging practices. We would like to point out, however, that the names of the bank's counterparties cannot be disclosed for data protection reasons. Instead, the information could be provided in aggregate form broken down by credit quality, for instance (investment grade/non-investment grade).

As regards hedging, it would be helpful to use the term "credit risk mitigation", and to clarify that the mitigants relate to those of entire securitisation positions rather than those within a securitisation transaction. Furthermore, it would be helpful to clarify the term "material" in "material hedge counterparties".

<u>(d): regulatory approaches</u>
We do not think that it will be helpful to relate methodologies to exposure types because their use is not exposure type dependent. IRB or standardised approaches (in the trading or banking book) may, and probably will, be applied to any exposure type.

<u>(da): types of SSPEs where the credit institution acts as sponsor</u>
This requirement seems to stem from the FSF recommendations on disclosure practices. Although we understand that the wish of regulators for such information to be provided, we do not think that such disclosure is relevant to Pillar 1 requirements. It should not, therefore, form part of the core Pillar 3 disclosures.

It is unclear what is meant by the reference to on- or off-balance sheet. Vehicles may be on- or off-balance sheet for accounting purposes. Their designation for regulatory purposes may not always be identical. In addition, certain exposures to securitisation vehicles may be regarded as on- or off-balance sheet. Any ambiguities in this respect will inevitably cause confusion for users. We would therefore request clarification that it is the regulatory perspective and thus product-related disclosure which is at issue here. Each individual exposure should be categorised as either on- or off-balance sheet for regulatory purposes. We also recommend including a category for derivatives.

(e): Summary of the credit institution's accounting policies for securitisation activities
In general, we believe that valuation and accounting policy disclosures are best covered in a bank's financial statements and would point out that most firms have been providing significantly more information since the financial turmoil began. We would urge supervisors to accept references to the banks' financial statements in Pillar 3 disclosures as an appropriate means of complying with the requirements rather than requesting similar, but not identical, information.

(g): Description of the IAA process
We are not clear on what this disclosure requirement is intended to achieve. Users are interested primarily in information about the relevant risks, not in the methods used to generate this information. This applies all the more given that internal rating methods are approved and regularly monitored by supervisors.

Should it nevertheless be decided to give users an overview of the methods used by a bank, it would be sufficient in our opinion to provide a qualitative summary.

We are not clear, moreover, on what these new requirements are expected to achieve, particularly in view of the following:
- What is meant by the structure of the IAA process? The relationship between internal ratings and external ratings is set by the framework since the IAA must be based on an ECAI methodology.
- Control mechanisms – while it would be possible to deliver some high-level information on the policies that a firm has in relation to its use of the IAA in calculating capital, it will not be possible to go into a great deal of detail because of proprietary considerations.
- Internal rating systems do not always use stress factors. If simulations are used instead, it will not be possible to indicate comparable stress factors.

Table 1

non-trading book

row 2: Amount of impaired/past due assets and losses recognised
The objective of this requirement is unclear. Is the intention to focus on all securitised exposures, i.e. which are off-balance sheet for regulatory purposes, or on the retained positions to which the firm is exposed? The second bullet would certainly appear to relate to the latter.

Furthermore, this requirement seems to relate to a mixture of accounting and regulatory information. We therefore consider it necessary to (a) define the scope more clearly and (b) clearly identify which elements of the requirement relate to accounting. The "impaired/past due" category does not reflect accounting terminology. The terms used for accounting purposes are "impaired" and "past due but not impaired". What is more, this information might not be available since there are assets where an "impaired" or "past

due" definition is not applicable (e.g. future flow assets) or where the pool is measured at fair value.

row. 3: Aggregate amount of on- and off-balance sheet securitisation exposures
We would draw attention once again to the problem of the different distinctions made between on- and off-balance sheet for accounting and regulatory purposes. We assume that it is the regulatory perspective which is relevant here (see also our above comments on Point 14 (da)).

row 4: Aggregate amount of assets awaiting securitisation
We understand the objective as being to capture assets where the decision to include certain assets in a securitisation has resulted in a change in accounting treatment. While this is reasonably clear in Point 14 (v), the scope here is not clear. In addition, commercial confidentiality considerations are involved in providing information on future securitisation transactions.

row 5: Breakdown by regulatory capital approach of securitisation exposures retained or purchased
This requirement effectively requires the delivery of a three- or possibly even four-dimensional table. We have reservations about the usefulness to users of introducing a breakdown by regulatory capital approach. Users are interested in the level of risk that a firm has assumed.

row 9: Breakdown of resecuritisation exposures
It would be helpful if the term "hedging/insurance" could be replaced with "credit risk mitigation". Furthermore, "financial guarantor" does not reflect the terminology used elsewhere in the Basel framework. It would also be helpful to explain the objective of this requirement, which appears to duplicate the requirement in Point 14 (d) (see above).

trading book

row 1: Outstanding exposures
The expression "total amount of outstanding exposures" is not precisely defined. This could refer, for example, to nominal or market values, gross or net amounts. Clarification is needed.

row 2: Total outstanding exposures securitised and subject to a capital requirement for market risk
This requirement raises the question as to its objective, especially given that the term "total outstanding exposures" is not defined. Please see our above comments on row 1.

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Furthermore, if the underlying portfolio is securitised and the securitised tranches are placed with third parties in their entirety, the bank has transferred the risk and there is no market risk remaining in the underlying portfolio. In this specific situation, disclosure of the underlying portfolio will consequently serve no useful purpose and should not be required.

<u>row 3: Aggregate amount of on- and off-balance sheet securitisation exposures</u>
The term "aggregate amount" is not defined. Please see our above comments on row 1.

Furthermore, a breakdown into on-balance and off-balance sheet securitisations exposures will not provide meaningful information about market risk (see also our above comments on Point 14 (da)).

<u>row 4: Aggregate amount of assets awaiting securitisation broken down by exposure type</u>
Please see our comments on non-trading book row 4.

<u>row 6: capital requirements for securitisation exposures in the trading book</u>
Our understanding is that the SFA may be applied to unrated exposures in the trading book. In our opinion, use of the SA, RBA and IAA is not possible in the trading book, however. Since we assume that this requirement cannot relate to counterparty risk in the trading book given the minor scale of the risk involved, it should be deleted. Furthermore, a reference to the standardised market risk approach should be included.

<u>row 7: Securitisations subject to early amortisation treatment</u>
The early amortisation treatment is typically applied to banking book transactions in which the loans to a bank's customers are securitised with the bank acting as originator of the securitisation. Since the underlying exposures cannot normally be assigned to the trading book and any repurchased securitisation positions would also be in the banking book, it makes little sense to apply this requirement to the trading book. We recommend that the row be deleted in view of the irrelevance of early amortisation rules for the banks' own trading book transactions.

<u>row 9: Breakdown of resecuritisation exposures</u>
The term "aggregate amount" needs to the defined. Furthermore, please see our above comments on non-trading book row 9.

Trading book

General comments

Against the background financial turmoil we can in principle understand the efforts of the supervisory authorities to do a thorough review of the capital requirements. However, in the future as well, the supervisory capital adequacy requirements should also match the risks of the trading book of the respective bank. We believe that an audit tailored to the situation of an institution is preferable to the one-size-fits-all imposition of a increase in capital requirements.

An important principle in estimating capital requirements by using internal models should be the coordination between the models and the supervisory requirements ("use test"). Fundamentally, we still have doubts as to whether it will be possible to meet the use test requirement for the modelling of incremental risk. Particularly in the area of measurement of incremental risks, for which no market standards have existed up to now, the (ongoing) development of models must not be restricted by rigid supervisory regulations. Institutions implement risk models primarily because these are more flexible and more appropriately adapted to their individual risk situation and portfolio composition. With rigid regulatory model specifications which are designed in a predominantly conservative manner, the advantage of an internal model is vitiated. The incentive for risk management based on an institution- specific model is thus significantly reduced.

Impact studies of the banking industry show that the proposed supervisory specifications for modelling incremental risks as well as the implementation of stressed -VaR result in an enormous increase in the capital requirements for the trading book regardless of the portfolio. This multiplication of the capital requirements has side effects. In our opinion, the capital-based incentive for the transition from the standardised approach for market risk to the internal models-based approach vanishes due to the increasing capital requirements for the latter method. This represents a negative incentive for the further internal development and supervisory use of risk models.

In addition, incentives may be created not to assign and manage risk positions in the trading book any longer, but to allocate them as far as possible to the banking book. The understandable desire of the supervisory authorities to avoid arbitrage opportunities in favour of the trading book has resulted in the creation of arbitrage opportunities in favour of the banking book. This becomes especially clear in the example of securitised loans: The capital requirements for securitised loans in the trading book shall for the future always be determined on the basis of banking book regulations. However, because such positions must additionally be taken into account in the standard VaR for general market risks (mandatory) and if necessary in the standard VaR for specific risk (optional) as well as in the stressed VaR (mandatory) for calculation of capital requirements, apparently intended arbitrage incentives are created in favour of the banking book.

A lack of incentives for trading book activities affect not only the institution itself. This lack of incentive can lead to a smaller number of market participants with the result that in less liquid markets higher margins can be established and thus the prices for many

financial services rise. The market distortions lead to arbitrage opportunities that can have a negative impact on the market prices.

Alternative Approach (Question a) of the Commission)

We strongly reject the proposal to introduce an alternative approach according to which the capital requirements for specific risk in the trading book would be determined solely according to the rules for the banking book. The application of the banking book rules to trading book assets with specific risks (e.g. only for non-liquid positions) would be a considerable step backwards on the path to a well-established risk measurement method for specific interest and equity risks. In addition, such an approach is also problematic due to the lack of risk sensitivity of the measuring procedure, as on the one hand market risks such as spread movements are not adequately reflected, and on the other concentration risks are not adequately taken into account.

Specific remarks

Directive 2006/49/EC

Article 3

With regard to the definition of resecuritisations, Article 3 refers to Article 4 of Directive 2006/48/EC. We reject this definition and refer to our above-stated comments on Article 4 of Directive 2006/48/EC.

Annex I

Point 16a, b, i und ii

In paragraphs 16 a) and b), three references are made to Annex IV, Part 4 of Directive 2006/48/EC. However, these references should all refer to Annex IX, Part 4 of Directive 2006/48/EC.

Furthermore, Annex IX, Part 4, No. 40 of Directive 2006/48/EC specifies the right to reserve approval for the application of SFA only for institutions that are neither originators nor sponsors. However, sentence 2 in 16 b) ii) specifies that all institutions - except for originators - require regulatory approval for the application of the Supervisory Formula Method. Here we request consistency with the previous banking book rules.

Annex I

Points 34 and 35

We do not feel that the increase in the capital requirement for specific risks for equities to 8 % and the elimination of the lower requirements for diversified portfolios are appropriate. The capital requirements for specific risk should continue to be based on the diversification of the portfolio. The financial crisis showed that while the volatilities increased for nearly all financial instruments, the risk in a diversified portfolio is still significantly lower than in an undiversified portfolio. We therefore urge that Point 35 remain unchanged and that the requirements in Point 35 be only modestly increased if at all.

Annex V

Point 5

According to the proposals for IR modelling, the institutions should be given a choice regarding the inclusion of equities, according to which IR modelling is to be omitted and backing can be provided according to the market risk standard approach. We welcome this possibility.

Point 5a

In IR modelling, an institution is supposed to document the default and migration risks. In our opinion, it should be possible to take into account diversification effects between these risks and other risks in the trading book in the model in order to ensure adequate capital requirements to offset the risks.

Scope

The financial market crisis made clear that an approach based exclusively on ratings is not capable of estimating the special risk factors of securitisations adequately. Thus it is astonishing that the Commission now wishes to rely completely on external ratings in the calculation of capital requirements. Particularly for banks using advanced models, this cannot be the right path. In view of the negative experience with external credit ratings of the external rating agencies during the financial crisis, we question why the Basel Committee does not rely more on the requirements of internal risk measurement methodologies.

The Commission proposes removing all securitisation positions from the determination of the IR capital requirements. We believe that this approach is too undifferentiated and wrong. This applies particularly to the securitisation transactions concluded with the intention of hedging. Hedge relationships are hereby artificially torn apart and actually

existing hedge transactions are negated. We believe that this approach is exaggerated and therefore request at least the opportunity to determine regulatory capital requirements in hedge relationships on the basis of the internal model. Insofar as there are reservations concerning the extent to which a hedge relationship is also stable in a stressed market situation, this challenge can be solved by a reasonable definition of the 'hedge relationship'.

Even for securitisations without hedge relationship, we consider it excessive not to permit them in the determination of the IR capital requirements based on the internal model. Depending on the complexity of the relevant securitisation structure, sophisticated institutions may be capable of internally modelling many of these instruments adequately. This will apply even more so in the future if the efforts of the institutions are taken into account in the improvement of the risk measurement for such instruments. These efforts should be promoted and not inhibited by the supervisory authorities. The extent to which appropriate models for securitisation positions exist can be checked by the supervisory authorities at any time. Institutions should therefore have the option of using their own product- or portfolio-specific models upon proof of suitability.

Finally, we request clarification that any necessary removal of certain transactions for the calculation of the IRC is not necessarily a removal of these positions from the internal model-based risk determination. This would diametrically oppose the character of the VaR as a portfolio approach and increase the discrepancy between the IRC model and internal model-based risk measurement.

Parameters

We view the use of the banking book specifications as a reference point and as a justification for the regulatory selection of a 'one year capital horizon and 99.9 % confidence level' as incomprehensible and incompatible with the conditions of a trading environment. For economic risk management, banks use risk management strategies that are not compatible with the assumption of a 'constant level of risk over a one-year capital horizon' which should also be taken into account in the calculation of the capital requirements. This would make the IRC considerably more appropriate with regard to risks and provide an additional incentive for the further development of internal risk management. To this extent we welcome the new provision in para 31. However, this option does not go far enough yet, as only 'dynamic hedging strategies' are discussed here, which however constitute only a part of the conceivable risk management strategies.

The floor of a three-month horizon appears considerably too high in view of the fact that the IRC is based on trading book positions. Rather, the institutions themselves should be responsible for determining appropriate liquidity horizons for the relevant positions. The establishment of a floor of three months prevents taking the various market situations into account appropriately. Should the supervisory authorities not be able to decide to give the responsibility for determining liquidity horizons to the institutions, we urge that a still conservative floor of only one month be used, as there are numerous positions for which a floor of three months would be too long, e.g. for positions that have a shorter residual

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term. Three months will also be too long for most loan products as well as for single-name and index CDS.

We assume that it is possible to assume a uniform liquidity horizon (' … appropriate liquidity horizon for a position or set of positions …', page 4) if as the floor conditions have been met. We request corresponding clarification.

Validation

We doubt that the stress tests mentioned in the second bullet point are suitable backtesting instruments. It should be primarily at the discretion of the institutions to carry out appropriate validation. Only after market standards for the modelling of incremental risks have been developed can detailed regulatory requirements be established for validation. At the present time the development of procedures that cannot contribute to validation of the model should not be pursued.

Frequency of calculation

A weekly calculation of the incremental risk charge is intended. The parameters underlying the model, particularly to assumed minimum holding period of up to one year, constitute an unreasonably long period for trading products. This is in contrast to the very short calculation cycle of the IRC. In our opinion, a one-week period is too short to integrate in the previous processes without difficulty. For one thing, the technical calculation cycles often require more than one night. For another, the data for the weekly calculation and the results calculated on this basis must undergo quality control and be integrated in the internal risk management process. In order to represent such a process on a weekly basis, personnel must be added and the technical systems further developed. This requires additional financial resources that again reduce the incentive for internal modelling. We therefore suggest aligning the IRC calculation with the other reporting cycles and recommend a monthly calculation. Should the supervisory authorities not be able to consent to this, at least the option should be granted to omit, on a weekly adjustment, non-essential parameters and extremely labour-intensive parameters. A purely quantitative determination of the regulatory figures would still be ensured.

Point 7

According to the specifications for determining the stressed VaR, the plus factor from Table 1 depending on the number of outliers by the institution's back-testing is not to be taken into account for the multiplier. The justification for the factor 3(+ plus factor) in the conventional market risk VaR as a factor for any existing model errors or model shortcomings cannot be applied to the concept of the stressed VaR. If one views the stressed VaR as a further add-on for model shortcomings, the factor 3 appears unmotivated at the model level as a further conservative appraisal for the VaR already determined under stress. In our view the multiplier should not be used in the stressed VaR.

Point 8

We welcome the new specification which German institutions have already followed for many years that requires evaluating the model quality of the VaR models exclusively on the basis of a clean backtesting approach. Only the comparison of the VaR estimate and the clean P&L, but not the comparison of the VaR estimate and the dirty P&L, permits an appropriate evaluation of the model quality. Because even international institutions which were previously allowed by supervisory authorities to carry out only dirty backtesting must in the future present clean P&L results, it appears to us to be inconsistent not to use these results for counting the backtesting exceptions as well. Dirty backtesting on the basis of the dirty P&L will generally show a smaller number of outliers than corresponding clean backtesting due to the generally positive contributions to the result contained in the dirty P&L which do not result from an risk taking. As the number of exceptions determines the backtesting add-on factor, the use of the dirty P&L results tends to lead to lower capital requirements with significant negative effects on the international competitive situation. Under Pillar III the number of these exceptions must be disclosed; the results thus on the public perception of the bank. The unpreventable mixing of outlier numbers on the basis of clean backtesting with the numbers from dirty backtesting in a comparison of institutions is a significant disadvantage for the institutions using clean backtesting and cannot be justified. Thus, for reasons of competition we urge that only clean backtesting results be taken into account, including for the counting of the backtesting exceptions.

Points 10

We explicit welcome the fact that the possibility of scaling a 1-day VaR to a 10-day VaR using the ‘root t’ formula will be retained.

Point 10a

In our view, the quantitative standards described far exceed the goal and will send the wrong management signals and impair the quality of internal risk management and supervisory requirements as well. The specifications for the determination of the stressed VaR will play a considerable role in the future in the determination of capital requirements and will be significantly above the capital requirements of the standard VaR for structural reasons. This will result in a decline in the importance of the standard VaR approach for capital management purposes.

Furthermore, in our view the consultation paper very rightly reinforces the importance of stress tests for internal management and monitoring by the supervisory authorities. However, we view the selection of relevant stress tests critically. Both the stress test procedure itself and the determination of the stressed VaR are based solely on specific historical scenarios.

Many years of observation of historical data have shown that even the ‘financial market crisis’ scenario in 2007/2008 was not very meaningful. Apart from the fact that both years were characterised by a very turbulent capital market, much higher volatilities in fixed-income instruments as well as equities were recorded in earlier years. Thus the highest interest volatilities in recent times were found in summer 2003. This makes clear that any period, no matter how carefully selected, is only of limited informative use. At the same time, the question of 'the' scenario will remain unanswered. Thus it should be possible to use a variety of scenarios to ensure appropriate stress testing that is suitable for internal management. In this process, all risk factors with their specific stress impact on a portfolio as well as the stress potential from encompassing crisis situations should be taken into account. The recommendations of the Basel Committee in the consultation paper 'Principles for sound stress testing practices and supervision' (CP 147) are also based on this; all relevant risk factors with their specific stress impact as well as the stress potential from encompassing situations should be recorded. Among other things, the complexity of any stress test programme is a reason why stress tests are so poorly suited as indicators for capital requirements.

Thus, in our opinion the actual purpose of stress tests should be kept in mind, namely for internal management and disclosure to third parties and the supervisory authorities. However, stress tests are not suitable for the determination of a regulatory capital charge.

Point 10b

If the determination of the stressed VaR is retained, we wish to point out the following: the design of the stressed VaR means that it is not possible for a situation rated as a ‘normal situation’ and another situation rated as a ‘stressed market situation’ to exist simultaneously. It would thus be considerably more plausible and would lead to more realistic capital requirements to link ‘stressed VaR’ and ‘standard VaR’ by means of maximum threshold instead of adding both capital requirements together.

Yours sincerely,

on behalf of the

Zentraler Kreditausschuss,

Bundesverband der Deutschen
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pp.

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