Comments

by the German Banking Industry Committee[1] on the European Banking Authority's draft RTS on the permanent and temporary uses of the IRB Approach

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The **German Banking Industry Committee** 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 finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

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On 26 June 2014, the European Banking Authority published a consultation paper on 'Draft Regulatory Technical Standards on the permanent and temporary uses of the IRB Approach under Articles 148(6), 150(3) and 152(5) of Regulation (EU) No 575/2013. We wish to thank the EBA for this opportunity to comment in the following on the draft RTS.

I. General comments

By way of departure from the policy under the 2006 CEBS Guidelines No. 10 (Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches), regarding the determination of the "exposures in non-significant business units as well as exposure classes or types of exposures that are immaterial in terms of size and perceived risk profile" (Art. 150(1) (c) CRR) the RTS Draft suggests a quantitative approach with a fixed ceiling for exposures that can be treated under the Standardised Approach.

In our understanding, the draft is thus geared towards the current policy adopted in Germany under the Solvency Ordinance (Sections 7-15 Solvency Ordinance). However, since 2006, in Germany said regulatory regime has had a rather negative track record. For instance, whilst not limited to, the rigorous German rules trigger mandatory inclusion of portfolios under the IRB Approach even if and when this is counterproductive from a risk management or economic perpective (c.f. also the comments on Article 3 for a more detailed discussion).

This is further compounded by the fact that the seeming simplicity of the definitions of the unweighted (Art. 3(a) Draft RTS) as well as of the risk-weighted (Art. 3(b) Draft RTS) "coverage ratios" is misleading. In Germany, the further debate on the rules highlighted the need for a continuous adjustment of the rules. However, such a continuous work in progress gave rise to increasingly comprehensive and ever more complex rules, that became increasingly unintelligible.

Last but not least, whilst the German regulation is already rather restrictive, it would become even more stringent still: Under the current proposals, the ceiling of 8 percent for (risk-weighted) assets eligible for treatment under the Standardised Approach shall and may not be exceeded in any case. Furthermore, in Germany, in order to ensure the feasibility of compliance in the first place, the definition of the "relevant exposures" had to be adjusted. Yet, there has been a failure to incorporate these amendments under the current proposal.

We also have serious concerns over the fact that the determination of the ceiling shall not only draw upon the exposure value but also upon the risk-weighted exposure value. The denominator of the risk weighted "coverage ratio" uses risk-weighted exposure values under the Standardised Approach. In the German Banking Industry Committee's (GBIC's) view, this ratio provides but an inadequate reflection of the exempted exposures i.e. it exaggerates the respective degree of risk. This is compounded further by the fact that it is far more exposed to volatile effects than the position based, non-risk weighted coverage ratio. Such volatilities result e.g. from rating changes, parameter reviews or currency rate fluctuations. They may have considerable implications on the level of the "coverage ratio". Yet, more often than not, they are beyond the banks' sphere of influence. In addition to this, if there is a reduction in the value of risk-weighted exposures calculated under the IRBA, the "coverage ratio" proposed under Article 3 Draft RTS would see an increase. Any reduction of the IRBA exposure's degree of risk would therefore reduce banks' eligibility for a permanent exemption under the IRB Approach. More likely than not, this is counterproductive with regard to the regulator's underlying rationale. Said approach would be especially problematic if and when a risk-weighted "coverage ratio", once it has been achieved, were to see an increase due to factors beyond the bank's control which reduce the risk of its credit portfolios. Whilst, *per se,* such a trend would be seen as positive, if and when it exceeded the 8 percent ceiling, this might trigger a need to include additional exposures under the IRBA. The development, implementation and adoption of internal ratings systems is a complex and lengthy process. Last but not least, significant third-party resources (on the part of auditors, supervisory authorities) will be required. This seems to rule out the option of an *ad hoc* inclusion whenever the coverage ratio is exceeded.

Hence, also in light of the experience in Germany, the GBIC holds the view that a risk-weighted coverage ratio would be unfit for purpose as a criterion for the measurement of non-significant business units that are eligible for a permanent exemption from the IRB Approach. Yet, in our view, on the other hand, the position based (non-risk-weighted) "coverage ratio" presents an appropriate, consistent ratio that is fit for purpose. This would also facilitate a reduction in the complexity of this regulatory framework. Hence, we feel that it is a more appropriate and adequate ratio for the calculation and assessment of an appropriate coverage ratio; consequently, we suggest dropping the risk-weighted coverage ratio.

In the GBIC's view, the "coverage ratio" within the meaning of Article 3 of the Draft RTS should reflect the share of exposures to which the bank does not apply internal ratings in those exposures for which the own funds requirements can generally be determined on the basis of internal ratings. Hence, whilst it is essentially correct to assess the share of the "relevant exposures" treated under the Standardised Approach in all "relevant exposures" In order to provide a true and fair view of the exposures not treated with internal rating systems, we recommend the implementation of the following changes during the definition of the "relevant exposures".

More specifically, as regards intragroup exposures and exposures within an institutional protection scheme which were exempted from the IRBA under the provisions of Art. 150(1)(e) and (f) CRR, it appears necessary to allow the banks to consider these exposures for the calculation of the "coverage ratio" as relevant IRBA exposures. Such a recognition should be subject to the precondition that internal rating systems are applied to these exposures that were approved by a supervisor and that the bank is capable of calculating its own funds requirements under the IRBA. *Mutatis mutandis, t*his should also apply to equity positions that are subject to internal approaches. Furthermore, in our view it appears indispensable to exempt securitisation positions from the relevant exposures. Our proposal is owed to the fact that their recognition would dilute the meaningfulness of this ratio. Also positions from expiring business units should be exempt since their consideration would be disproportionate and financially unviable.

In our preliminary understanding, wherever the national supervisors are not granted any explicit discretion, the national provisions (e.g. the Solvency Ordinance rules in Germany) would lose their applicability after the coming into effect of the RTS. Hence, it would appear helpful to introduce a grandfathering rule. More specifically, it would be a violation of the principle of proportionality if banks that are already allowed to use the IRBA were suddenly denied the application of the IRBA due to the potentially forthcoming stricter definition of the coverage ratio.

We endorse separate ceilings on an individual and consolidated level. At this point the ceiling on a consolidated level should be higher than the individual bank's ceiling. In the event of an approval on a consolidated level with an ceiling like on the level of the individual bank, also very small subsidiaries would have to obtain the IRBA approval in order to be able to comply with the ceiling on a consolidated level. We would like to reiterate that, more often than not, this will be very difficult given the financial viability and / or model technicalities.

II. Specific Comments

Article 1(1) (Terminology)
We would like to reiterate (c.f. "General Comments") our recommendation of merely using the "exposure value" as a coverage benchmark. We suggest abandoning the "risk-weighted exposure amount".

Article 1(3) ("Relevant exposures" for the purposes of application of Art. 150(1) c CRR)

We would like to reiterate our caveat made under the "General Comments" section: In the German experience, implementing the 8 percent rule requires adjustments to the definition of "relevant exposures". Otherwise, meeting the stringent requirements will be virtually impossible. The GBIC is of the opinion that the coverage ratio specified under Art. 3 Draft RTS should answer the following question: Which share do exposures that are not treated with internal ratings by the bank have in exposures for which the own funds requirements can generally be determined on the basis of internal ratings? Hence, it is essentially correct to express the ratio of the "relevant exposures" which are treated under the Standardised Approach by referring to the "total relevant exposures". In order to provide a true and fair view of the exposures not captured by means of the IRBA, we recommend the implementation of the following changes during the definition of the "relevant exposures".

Exposures which should potentially count towards the "relevant exposures"

On principle, exempting **equity positions** from the regulatory scope of "relevant exposures" seems to be fit for purpose. This is due to the fact that this exposure class may draw upon a simple approach that is not based on internal valuations. However, as a consequence, the use of internal approaches for the determination of own fund requirements for investment positions (PD/LGD or model based approach) does not have any impact on the amount of the "coverage ratio". In order to give banks an incentive for the introduction of such approaches, the GBIC holds the view that they should be allowed to count equity positions for which the own fund requirements were determined under the PD/LGD approach towards "relevant exposures".

Intragroup exposures as well as **exposures within an institutional protection scheme**, which the bank has exempted on a permanent basis from the application of the IRB Approach under the provisions of Art. 150(1) (e) and (f) CRR shall be exempt from the "relevant exposures". On principle, this is correct. However, notwithstanding the determination of the own fund requirements, within banks such exposures are frequently valued by means of an IRB Approach that has been approved by the supervisor. The GBIC is of the opinion that - in order to pay tribute to the use of such approaches approved by the banking supervisor (and the costs thus incurred) - such exposures should be counted as "relevant exposures". The corresponding exposures should be factored into the calculation of the "coverage ratio" as IRB Approach positions. Consequently, banks should be able to calculate the risk-weighted exposure values under the IRB Approach.

Exposures which should not be regarded as "relevant exposures".

In **securitisation positions,** the capital adequacy requirement is generally not calculated by means of internal ratings based approaches. Apart from the Internal Assessment Approach (IAA), the differentiation between SA and IRBA positions is based on the approach which the bank applies to the "predominant share" of the securitized portfolio (Art. 109 CRR). Consequently, in our view using SA positions in the denominator of the "coverage ratio" does not constitute a reliable indicator for the share of the positions the bank is not treating with internal rating systems. For this reason, securitisation positions should be exempt from the "relevant exposures".

Also, expiring **business units** i.e. business units in which the bank no longer concludes any new transactions should be exempt from the "relevant exposures". The GBIC holds the view that the mandatory development and introduction of a rating approach for these exposures would not be possible or, moreover, financially utterly unviable. At least, areas in which no new transactions have been concluded since the CRR's first-time application should be eligible for an exemption.

At present, it remains unclear whether **exposures to a qualified central counterparty**, which have been assigned a risk weight of 2 percent under the provisions of Art. 306(2) (a) in conjunction with Art. 301(2) (a) CRR constitute an SA position or an IRBA position. A corresponding query has been submitted to the EBA as part of the Q&A process; to date, the answer is still pending. Should these exposures constitute SA positions, we recommend exempting them from the regulatory scope of "relevant exposures".

In our preliminary understanding, in terms of the treatment of **investment funds,** the EBA proposal means that non-investment positions underlying a funds shall be counted as "relevant exposures". In our view, the investment fund's non-investment positions where the bank carries out a weighting on the basis of Art. 152(2) (b) by way of analogy to the Standardised Approach would have to be assigned to the denominator of the “coverage ratio”. We have extremely strong reservations over this fact. In the GBIC's opinion, exposures in the form of investment funds should be completely exempt from "relevant exposures".

Furthermore, it is worth noting that exposures eligible for exemption under the provisions of Article 150(1) (a) (b) CRR shall not count towards "relevant exposures" for the purposes of applying Art. 150(1) (c) CRR. For banks applying these rules this would result in considerable additional scope for using the Standardised Approach. In the extreme case these banks could initially exempt respectively 8 percent for each of the two exposure classes of their exposures under Art. 150(1) (a) and (b) CRR from the application of the Standardised Approach. Subsequently, out of the remaining "relevant exposures" they might treat an additional 8 percent under the Standardised Approach. The GBIC is well aware of the fact that, by means of the provisions under Art. 150(1) (a) and (b), the EU legislator sought to establish the option of additionally exempting exposures from the IRBA on grounds other than those warranted under Art. 150(1) (c) CRR. However, potentially this rule might at least to some extent give rise to competitive distortion. Banks which are not capable of exempting their sovereign or banking exposures under the provisions of Art. 150(1) (c) CRR should be given the opportunity to exempt from the "relevant exposures" small residual portfolios in these exposure classes which are not subsumed under the scope of an approved IRBA rating system. Alternatively, it could be considered to raise the 8 percent ceiling for these institutions.

Article 2 (Permanent Partial Use for Exposures to Sovereigns and Banks)

Under the provisions of Article 150(1)(a) and (b) CRR the eligibility criterion for permanent Partial Use is that the number of material counterparties is limited and that it would be unduly burdensome for the institution to implement a rating system for these counterparties.

Thus, the CRR rules are <u>neither</u> predicated on the risk nor on the volume of the exposures to these counterparties. This is an explicit and deliberate decision on the part of the EU legislator. In this respect, the provisions under Article 2(1) (a) and (b) Draft RTS, according to which the (risk-weighted) exposure values of the exposures to sovereigns and banks shall and may not be any higher than 8 percent of the "relevant exposures‟ are in breach of the CRR requirement; hence, we hold the view that it has to be deleted. Whilst the German implementation of the Solvency Ordinance is highly restrictive, even the German implementation does not feature such a stringent requirement.

In our view, 20, i.e. the proposed number for the immaterial counterparties is too low - at present up to 40 counterparties can be exempted in Germany. This requirement could also serve as the basis for the European requirement. Unless it will be dropped in line with our recommendations and whenever there is a restriction compared to the current national rules, the more restrictive approach which can be witnessed at least in Germany seems to suggest that the transition to the more stringent requirements features an urgent need for grandfathering rules.

Article 3 (upper threshold)

In order to be eligible for the application of Art. 150(1) lit. c CRR Art. 3 Draft RTS sets out that exposures treated under the Standardised Approach shall and may account for no more than 8 percent of all relevant exposures. In our view, this fixed, excessively low and inflexible ceiling generates the need for compulsory application of the IRBA also to those portfolios where this is uneconomic and unnecessary for risk management reasons. At this juncture, there is the danger that the resources which need to be invested into the preparation of rating systems for immaterial portfolios are missing when it comes to the improvement of the rating systems for material portfolios. Furthermore, the experience to date in Germany shows that an increasing degree of IRBA coverage translates into higher costs for banks. The closer the attained coverage level gets to the "exit threshold" of 92 percent (minimum IRBA coverage) currently applicable in Germany, the more granular und specialised the portfolios become. Given the diminishing returns on the coverage ratio, the costs associated with the development of appropriate rating approaches for these portfolios fail to meet the principle of proportionality.

Furthermore, the development of rating systems for portfolios merely featuring a limited number of borrowers (other than the sovereign and banking portfolio) is frequently encumbered by problems. Therefore, more often than not, a compulsory roll-out for such portfolios leads to a situation where the corresponding rating systems will not receive supervisory approval resulting in a failure to meet the coverage ratio. Based on the foregoing, such portfolios should be exempt from the roll-out obligation.

One example of inflexible rules consists in the obligation for A-IRBA banks to estimate own estimation based LGDs in the sovereign portfolio. We have strong reservations over this proposal and suggest deleting it. Provided this decision is not motivated by regulatory cherry-picking in terms of own funds requirements, A-IRBA banks should be granted the option to chose the portfolios for which they use LGDs based on own estimations.

Both on the grounds of risk control but also for financial viability reasons it may occasionally be helpful to refrain from an IRBA roll-out to all portfolios necessary for achieving the necessary coverage.

Therefore, the proposed exposure share of 8% maximum eligible for treatment under the SA is clearly too low. In our view, in order to be economically viable, this ratio should be at least 20%. This is the only way of at least mitigating the aforementioned compulsory obligation. Furthermore, during the homologation process and in the presence of substantive reasons, it should be possible to exceed our proposed ceiling upon request by the bank. Whilst not limited to, one example of such a substantive reason would particularly consist in proof that the necessary implementation effort in smaller portfolios fails to live up to a cost-benefit analysis (principle of proportionality). At this juncture, the "unduly burdensome" specifications under Art. 2(2) Draft RTS should be used. Also in light of these rules, the GBIC holds the view that the conditions set out under Art. 150(1) (c) CRR are met. Furthermore, the choice between IRBA and SA shall and may not be motivated by regulatory cherry picking in terms of own fund requirements. This increasing degree of flexibility may also enhance the credibility of the results thus contributing towards regaining trust.

Article 4 (Temporary Partial Use)

There should not be any quantitative rules concerning the lead time granted to banks prior to "comprehensive" application of the IRBA. This is inconsistent with the notion of the Single Rule Book; on the whole it can thus distort the envisaged level playing field.

In order to avoid any divergence of rules promulgated by national supervisors, the EBA would have to specify in greater detail how to interpret the language "potential for underestimating the risks‟ under Art. 4(1) (e.g. when does a high potential exist or, moreover, with regard to which portfolios does it exist?).