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Bank for International Settlement
Basel Committee for Banking Supervision
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Schweiz

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Attachment

[Dear Danièle,]

in the course of the second consultative period on the New Basel Accord, German banking supervisors received approval on the guiding principles of our package. Furthermore, German banks included a wide range of specific suggestions on the second Consultative Paper in their remarks. With this letter and the enclosed attachment, German supervisors would like to draw the Committee’s attention to the comments of the German banks and industry on the proposed New Accord. Further, we would like to let you know that we expect the German Parliament (Deutsche Bundestag) to take an active stand on central issues through a second resolution (Bundestagsentschließung) in the near future. Additionally, Gerhard Hofmann, Deutsche Bundesbank, and I would herein like to emphasize the aspects of particular importance.

The German banking industry supports the increased risk sensitivity of the proposed New Accord that incorporates the supervisory recognition of core banking skills, namely the bank-internal evaluation of credit risk. Such development will strengthen the banks’ ability to fullfill their economic role in providing the economy with financing opportunities. It is also recognized that this increased risk sensitivity will imply increased capital requirements on

high risk exposures being counterbalanced by the treatment of high quality assets. German banks took further note of the fact that the Committee considered legitimate remarks from the international banking industry amongst others during the first consultative period. This encouraging mutual understanding is seen as the main road leading to an increased financial stability.

In view of the outstanding record regarding financial stability, German banks especially support the effort to preserve an unchanged level of overall capital requirements throughout the banking industry. Two aspects are taken as key preconditions for a successful completion of this central feature within the New Accord: Firstly, this achievement will be assured by an unchanged definition of a bank's capital, which secondly goes along with a thorough and consistent calibration that translates relative capital charges into adequate absolute requirements.

To assure the success of this project, German banks urge the Committee to clarify the loss concept underlying the calibration of absolute capital. The banks hint to the fact that the Committee's decision to leave the definition of capital unchanged necessitates a calibration that focuses on unexpected losses only. Expected losses are captured in the pricing of credit exposures as well as through provisions which are currently included in the definition of a bank's capital only to a marginal extent. Consequently and in case of a inconsistently specified capital, the whole risk category of expected losses might be double counted. Such treatment could possibly be avoided through extending the definition of capital by including provisions and future margin incomes. Nevertheless, those changes would extend far beyond the loss concept of the current Accord and are not in line with the prevailing industry practice. It further remains questionable, if such an extension could be limited to the above named items. Germany does not oppose any negotiation on the definition of capital but takes the view that this would render the existing time frame obsolete.

In this context, German banks highlight the effect that envisaged capital charges for operational risk will exercise on the overall requirements for banks with large trading book exposures: These banks benefit from reduced capital requirement for credit risk to a limited extent only. Nevertheless, the requirement for operational risk refers to overall banking activities that include the trading book. Consequently the latter capital charge would most likely overcompensate the former limited capital relief. Differently stated, the overall level of capital requirements will increase for those banks. In view of this challenging calibration project German banks are fully prepared to further contribute and take an active and supportive position.

Having expressed these concerns, German banks do recognize that these issues have not been decided and that input from the industry will form an integral part of the basis on which a future decision will be grounded. The past opportunities to comment on the New Accord gave the necessary confidence that this vital issue will not be decided without paying respect to a high quality and consistent framework as has been experienced in the past. The banks are willing to contribute to align industry practice with supervisory norms. Nevertheless, German banks are aware of the envisaged ambitious timeframe where a third consultation could run counter to the schedule set up by the Committee. Thus, to strike a compromise, the continuous consultation on key issues may function as a substitute. German supervisors see the legitimate motivation of the industry in offering this support and take a favorable view on this proposal.

The received comments from the German banking sector extend beyond these forward looking aspects and hint towards the need for clarification of specific issues. The dominant concern relates to the impact the specific design of the New Accord could have on current market practice. Well established long term customer relations with their extensive understanding of the current risk profile need to be preserved. Further, the New Accord should not endanger existing financing opportunities that could destabilize a whole economy. German supervisors strongly support this request.

In particular, small and medium sized enterprises (SME), the so called Mittelstand, form a cornerstone of the German economy. The sector diversity of the Mittelstand possessing highly valuable specialized skills and their low bureaucratic costs render these businesses most productive. These highly flexible companies form the platform that enables the use of new technologies and thus supports structural changes leading to higher employment and growth. While the focus of these businesses has traditionally been local, increased competition due to globalization will most likely not endanger the quality of these companies. Consequently, the observed globalization may rather be seen as additional business opportunities that enhance the credit quality of the Mittelstand.

Thus, for supervisors, there is no grounds for any reservation against the prospect of a continued good credit quality of the Mittelstand. Furthermore, a significant share of those Mittelstand companies tie its economic fate directly to the personal wealth of the managers owning the company. This tie may either take the form of a legal structure, by which the company is set up, or, alternatively, that banks‘ exposures to such companies are secured by the private wealth of the owners. This direct link does assure a prudent behavior from the

companies’ side in credit taking that complements the banks’ risk management. It is the view of German supervisors that such self sustaining relationships of prudent credit demand meeting comprehensively informed banks should also be taken into account within the new framework.

Specifically, supervisors should not discourage such solid and sustainable market structure when shaping the details of the New Accord. Particularly, the combination of a company’s fate to private wealth should enable a bank to treat such exposures as claims against private customers when the latter is seen as the dominant debtor characteristic. Additionally, exposures to such companies may present collateralization options that are not available to large firms. Here, life insurance and physical assets serving as collateral are of striking relevance. Such a treatment would not run counter to a prudent capital treatment since the bankruptcy of such a company entails harsh consequences for the company’s owner thus assuring a prudent behavior.

A destabilizing effect of the New Accord may also arise from any additional burden put on long term exposure. Depending on the specific regulation on maturity, the term-structure may be driven towards short term exposures. In view of the established long term customer relationships of German banks, this market character has significantly contributed to the financial stability in Germany through multiple channels. These stabilizing effects materialize through an increased planning certainty for company investments, improved long term finance opportunities for those small companies with limited access to capital markets, reliable long term costs for the economy and, most important, extensive mutual understanding of the individual exposure’s risk. In view of this given German market structure of long term credit relationships - which we regard as prevailing for main parts of Europe as well -, German supervisors seek to encourage such behavior.

Additionally, the economic reasoning behind a maturity regulation should be reconsidered. Specific regulation on maturity may also entail undesired consequences for national economies. If long term exposures included relatively high capital charges, banks would incorporate the increased costs within their margin calculation. Further to this, long term credit relationships also play a stabilizing role for the world economies. The sum of these effects would possibly even render a privileging regulation of those exposures imaginable. If any economy is particularly stable in this respect, a calibration of the overall capital requirements based on average maturity would punish such an economy. Consequently, such an Accord specifications would run counter to the general purpose of creating a more risk sensitive regulation.

On the calculation of relative risk weights, German banks regard the capital treatment of exposures with different credit quality as overly divergent. This concern may particularly be relevant in a economy facing a downswing. If regulatory capital charges place overly harsh constrains on exposures that migrate down in quality, the regulatory framework may induce procyclical effects.

A further issue where German banks built up long-standing experience relates to equity holdings. This type of exposure holds a firm position in the banks‘ investment strategies. Simultaneously, these relationships prove the long lasting relationships of a bank to its customer. Banks frequently decide to use their superior expertise not only for credit relations but also for investment purposes. Consequently, supervisors may interpret such investment as an indicator of profound trust of a bank in a companies‘ future development. As such, banks are able to determine probabilities of default for such exposures and allocate capital for unexpected losses due to default in a fashion that is consistent with the general framework. Further, from an economic perspective, a bank’s risk stemming from equity may be considered comparable to a junior credit exposure while the latter will not profit from any upside chances.

Within this context, German banks hint towards the fact, that a mark to market methodology for equity exposures would be inconsistent with the focus of the banking book. Such an approach would give market risk a disproportionate influence on the required capital charge. Thus, the valuation basis should not be the highly volatile market value but rather the book value. This approach would incorporate the fact that short term price changes would not influence the perceived riskiness of those long term oriented exposures. Germany views such a regulation as being consistent with the relevant time horizon in the banking book.

Taking these legitimate remarks into account, German supervisors support the economically motivated request to use the PD/LGD framework for calculating the capital charge on equity and private investments. Such framework would be in line with the general concept underlying the Internal Ratings Based Approach. In contrast, the market value of a given exposure should not be given a central role since the banking book contains assets with a long holding period. Thus, legitimate concerns directed towards changes of a market value which are relevant within the trading book regulation are less compelling in the given context.

Next to the specification of the Internal Ratings Based Approach, German bank criticize the proposed data requirements during the transition period. Given the proportional increase of

these requirements over time, banks without the necessary data in 2004 will, in practice, be excluded from applying the Internal Ratings Based Approach during the transition period. As a consequence, the transition into the Internal Ratings Based Approach during this period would be highly unlikely so that the probable entry dates would be restricted to the years 2004 and, at the earliest, 2007. German supervisors are convinced that transitional data requirements should enable banks, also in practice, to enter into the Internal Ratings Based Approach at any time.

Further, German banks mention that entry preconditions to the Internal Ratings Based Approach should take bank specific circumstances into account. Particularly, the importance of thorough risk measurement also depends on the business structure of the bank in question. Thus, for clearly identifiable business lines, the requirement of an aggressive plan to adopt the Internal Ratings Based Approach may be overly ambitious. Here, the potential contribution of these areas to the complete risk position of the bank may be considered as marginal. Consequently and depending on the individual bank's portfolio, the so-called aggressive adoption plan should rather be specified as reasonable.

Within the Standardised Approach, the unsecured portion of any asset past due for more than 90 days will attract a 150% risk weight. German banks rightly highlight, that secured claims do, in any circumstances, contain relatively lower risk than unsecured ones. This particularly holds true in the case of existing supervisory recognized collateral. For this reason, past due preferential real estate lending still contains relatively lower risk that would not justify such a high risk capital charge. Rather, the portion of the exposure secured by the supervisory recognized part of a mortgage should be exempted from this risk category. To assure a prudent evaluation in calculating the mortgage value a haircut for market volatility could be considered.

Finally, German banks hinted towards the fact, that information processing capabilities are limited and costly. Consequently, an overly vast pool of information would make their use rather problematic since core data are mingled with complementary information. Such mixture would render the processing more complex and time consuming since relevant information needs to be isolated. For these reasons, a focus on limited core data may improve the timely availability of a comprehensive judgement in a cost-efficient manner. Further, German banks hint toward the property rights of sensitive data on their business strategies and the outcome of internal costly analysis. Given the competition, a forced disclosure of private data may prevent the exercise of further analysis thus reducing the degree of information in the market. Due to these concerns, German banks would favor the

limited disclosure of core data to the market. Highly sensitive but indispensable data may be reported to the national supervisors to provide a complete and profound picture. German supervisors recognize the increase of information may, beyond a certain threshold, result in negative marginal utility.

German supervisors are convinced that the extensive comments by German banks and industry do not stand against a compliance of our ambitious time schedule. We further believe that the issues in this letter form a comprehensive summary of the key concerns that need to be considered at the Committee level.

Yours sincerely,

Dr. Burkhard Lehmann

This letter has been mailed electronically; it does not have a signature