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Discussion paper of the Association of German Banks on possible ways and means of simplifying regulation

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Dear Mr Byres,

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Prepared by Ga/Rd

Enclosure
Discussion Paper

On 8 July 2013, the Basel Committee published a discussion paper on Balancing risk sensitivity, simplicity and comparability. This paper looks at ways of reducing complexity and improving comparability, while preserving existing risk sensitivity if possible. "Simplicity" of regulation is explicitly recognised for the first time as an additional objective of the Basel framework.

The Association of German Banks applauds the Basel Committee's efforts in this area and would like to contribute pro-actively to the discussion on simplifying regulation. To this end, we have drafted the enclosed discussion paper.

In our discussion paper, we show that the excessive complexity of regulation is due mainly to the plethora of requirements affecting banks and to the degree of interplay between regulatory measures that can now scarcely be assessed, let alone properly controlled. This frequently gives rise to problems because of overlapping and conflicting requirements that provide contradictory stimuli. We therefore make specific proposals for improving the standard-setting process in order to avoid any further increase in complexity and to reduce already existing complexity.

This discussion paper is an excerpt from a more extensive paper and focuses only on international aspects of simplification.

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We trust that our discussion paper will meet with your interest and should greatly appreciate an opportunity to discuss it with you in person.

Yours sincerely,

Michael Kemmer
General Manager
Member of the Board of Directors

Dirk Jäger
Member of the Management Board

P.S.: A similar letter has also been sent to Mr. Mark Carney (FSB).

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23 July 2013

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1 Management summary

Since the onset of the financial crisis, a massive wave of regulation has swept over the banking industry. The private banks support stabilisation of the financial sector and the regulatory measures this requires. The present level of regulation is, however, no longer justified in our eyes. Regulatory measures may well be legitimate individually. But, taken as a whole, they produce a degree of complexity that neither banks nor supervisors can fully assess.

This complexity is not caused by individual regulatory measures but by the sheer number and intricacy of rules and regulations. Some measures are intertwined with overlapping and often conflicting requirements. This produces contradictory stimuli that seriously hamper management of a bank and may, in the end, unintentionally lead to destabilisation of the financial system. At the same time, the distribution of functions between international, European and national regulators is not always clear and free of tension. Finally, the banks affected have to comply with different comprehensive reporting requirements which are not only burdensome but also so complicated that they confuse investors and obscure the focus on the real issues.

Simplification is therefore urgently needed to make the existing regulatory landscape more comprehensible and manageable for all concerned. Simplification does not mean lowering capital requirements but taking a closer look again at ways and means of harmonising the different prudential requirements and aligning accounting and prudential standards. When considering the options, the enormous costs caused by more and more new measures and the current heterogeneous regulatory landscape should also be borne in mind. This cost burden impairs the ability of banks to strengthen their capital base so that they can survive in the marketplace in the long term and supply the business sector with financial services.

To safeguard the stability of the financial system in the long term, consideration should therefore be given to reducing the existing complexity of regulation and avoiding any further increase in complexity:

1. Improving the regulatory standard-setting process to avoid any further increase in complexity:
   a. When new standards are drafted, more attention should be paid again to proportionality, materiality and a principles-based approach.
   b. Rulemakers should make a point of examining interplay with and impact on other areas of regulation and consulting with the relevant standard-setters at an early stage.
   c. All stakeholders should be consulted adequately at an early stage.

2. Reducing already existing complexity:
    a. Accounting and prudential valuation methods should be largely uniform. Different "fair values" and "prudent values" confuse supervisors, management and investors.
    b. Reporting for regulatory purposes should be harmonised, giving due regard to accounting standards.
    c. IFRS should also be applicable to single-entity financial statements.
    d. The parallel application of "going concern" and "gone concern" approaches that is being increasingly called for under Pillar II should be abandoned.
    e. All stakeholders should use the same terminology and develop a common understanding of the different aspects of regulation.

2 Why is simplified regulation needed?

In the wake of the financial crisis, the international banking sector is experiencing a raft of different regulatory measures. The Association of German Banks generally supports efforts to improve the regulatory environment so as to in this way make a contribution towards stabilising the financial system. Viewed separately, each regulatory measure may well be legitimate. Yet not only the Association of German Banks but, in the meantime, also the European Parliament's Economic and Monetary Affairs Committee (ECON) have the impression that regulation is repeatedly adopted without agreeing it with other rules and without taking interplay into account. This produces a whole host of difficulties, conflicts, ambiguities and inconsistencies. It also leads to growing complexity when it comes to compliance with this regulation.

With the above remarks in mind, and in line with the thinking of economist Peter Ulrich as well as the ideas of systems and decision theorists, "complexity of regulation" may be defined as follows:

"Complexity" is caused by the (over-)diversity or plethora of requirements affecting banks and by the degree of interplay between these requirements. (P. Ulrich/E. Fluri: *Management. Eine konzentrierte Einführung*, 7th edition, 1995, UTB, Stuttgart). Complexity in this sense is characterised by a decision-making situation that cannot be structured (it is not possible to keep track of the amount of interplay). Hence, the adequacy of decisions measured against the customary internal bank objectives cannot be checked. It may, moreover, be the case that in a complex regulatory environment a decision supports individual objectives pursued by a bank, whilst it is at the same time an obstacle to achieving other objectives (conflicts of objectives, dilemmas). The new regulatory environment has now become so complex for regulators themselves, too, that cumulative effects and interplay can no longer be fully assessed.

Given these conflicts of objectives, complexity needs to be reduced. Complexity is increased (reduced) by increasing (reducing) the number of requirements and/or by more (less) interplay

between requirements. This process is non-linear. If a reduction in this sense is not possible, the inconsistencies and disregarded interplay that exist should at least be identified. The present position paper aims to make a contribution in this respect.

A distinction must be made between the complexity of regulation as defined above and the quite noticeable complexity of internal models. The growth in model risks due to the use of complex mathematical-statistical models for internal and regulatory purposes is not a reflection of the increasing complexity of regulation. This type of complexity is usually the result of model developers duly responding to financial market trends (e.g. product innovation in the derivatives or securitisation sector) that have to be taken into account in development of models. If these trends were ignored, models would quickly prove inadequate and would be no use for internal risk management purposes, for example. But internal usability is wisely tied to regulatory usability (use test) at the same time. It would not therefore be helpful to address this type of complexity by abandoning the models used for regulatory purposes. No regulatory standardised approach or non-risk-sensitive regulatory approach (e.g. a leverage ratio) can measure banking risks adequately and be compatible with banks' internal incentive regime. Dispensing with the use of internal models for regulatory purposes would merely mean turning a blind eye to the complexity of the financial markets and would create dangerous, misdirected incentives.

Ultimately, the complexity of a specific individual regulatory provision or a specific individual model is not a problem. What is a problem is regulatory diversity, whereby individual transactions may fall under different rules and regulations or under more than one model.

3 Key criticisms of current regulation

As explained above, the complexity of regulation is a multifaceted problem that can be described as follows:

- There is a wide range of partly differing and partly also overlapping or conflicting **requirements** due to the establishment of **several** externally enforced **management processes**, such as
  - accounting management processes (German Commercial Code [*Handelsgesetzbuch* – HGB], IFRS, US GAAP),
  - prudential management processes (solvency ratio, leverage ratio, liquidity coverage ratio, Pillar II),
  - prudential/accounting management processes (due to the fact that accounting and prudential valuation methods are tending to drift further and further apart),
  - tax management processes and
  - internal risk management.
- Sometimes regulation **conflicts with, duplicates or interplays with** other legislation and sometimes **individual regulatory measures** conflict with each other. For example, different

terminology is often used in various rules and regulations for basically the same cases, or the same terminology is used for different cases. This causes misunderstandings and imposes an additional explanatory workload.

- The banks affected are subject to comprehensive **different reporting requirements**, e.g. risk reporting for accounting purposes and prudential Pillar II disclosure.
- Regulation is **not** sufficiently **principles-based** and there is instead a tendency to adopt detailed rules. The principles of **proportionality and materiality** are **not respected** enough.
- As we see it, the **distribution of functions between** international, European and national **regulators and supervisors** is not always **absolutely** clear. This causes a number of additional problems:
  - There is a tendency to adopt excessive regulation which – if at all – only delivers marginal added value in some cases.
  - The same rules and regulations are often interpreted differently by different enforcement bodies (e.g. different national banking supervisory authorities).
    --> "Complexity due to double and multiple supervision"
  - In some cases, banks actually face conflicting requirements set by different bodies.
  - The number of ad hoc inquiries from various supervisors (in Germany and at European/international level) about the same issues in the course of operational supervision continues to grow, causing a considerable additional processing and consultation workload, especially as the information requested is often already available in other reports issued by supervisors.
  - Responsibility for individual regulatory measures is "passed back and forth" between individual regulators. This is reflected, for instance, in the reluctance on the part of supervisory authorities to, for example, take a clear line regarding the standards to be applied by a bank or to provide binding guidance on how to interpret specific regulation.

These key criticisms show that a great deal of complexity results from the numerous regulatory measures that exist separately alongside each other. Yet regulators often do not display enough willingness to consult with one other in the early stages of any planned regulation. They do not have a full picture of the current regulatory landscape. In our eyes, the scope for convergence within different prudential rules and between prudential and accounting rules is not reviewed regularly enough.

It is right that the measures adopted by individual regulators and standard-setters in the area of accounting have a different objective or different purpose in some cases. But it is also right that an isolated approach to the numerous different regulatory measures and reporting requirements is inappropriate and only serves to create complexity.

To remedy this unsatisfactory situation, it is vital that – particularly in the area of prudential regulation – all the parties affected by a regulatory measure are involved at an early stage. This

calls for a clearly defined standard-setting process. Proposals for improving this process are therefore outlined in the following.

4 Proposals for improvement

4.1 Regulatory standard-setting process

To obtain better regulation, it is crucial that all the parties affected are involved in the regulatory process early. In our eyes, the area of prudential regulation lacks a clearly defined standard-setting process that all stakeholders can understand.

The stakeholder consultation mechanisms that are usually in place have room for improvement. The prudential standard-setting process should therefore be based on how standards are set in the area of accounting. In this area, there has long been a clearly defined process which ensures that newly drafted standards are usually of a high quality and meet the requirements of the different groups of addressees at the same time. Thanks to its structure, with appropriate monitoring and advisory bodies, the International Accounting Standards Board (IASB) is generally independent of political influence. Yet the IASB should not ignore certain overarching international developments (e.g. discussion on impairment) and requirements, as formulated by the G20, for example.

In our view, a **regulatory standard-setting process** should take account of the following aspects:

- Rulemakers should examine interplay with and impact on other areas of regulation and consult with other standard-setters at an early stage.
- The banking industry should be involved in the standard-setting process at an early stage.
- Before publication of a consultative document, industry and association experts should discuss the imminent regulatory issues with representatives of the supervisory authorities. Working drafts of consultative documents should therefore be made available to these experts on a confidential basis prior to publication of a consultative document.
- The final – and usually published – draft of the new regulation should be made available for written consultation. This written consultation process should allow a reasonable period of time for submitting comments. Only then do stakeholders have the chance to fully analyse and assess the final draft.
- On completion of the written consultation process, and depending on the subject and the comments received, there should be an opportunity for a verbal exchange of opinions.
- Depending on the subject and implications of the imminent regulatory measure, impact assessments should be conducted before a standard becomes legally effective.

- The comments and remarks received, the exchange of opinions and the results of any ex ante impact assessments should be fully evaluated and incorporated into publication of the final standard.
- Before publication of the final standard, a last check should be made on terminology and on interplay with other areas of regulation.
- An adequate transitional period of at least twelve months is required between publication of the final standard and its application for the first time.

4.2 Principles of regulatory standard-setting

When drafting new rules, rulemakers should, however, take into account the impact of their rulemaking on market expectations. For example, phased-in application of the Basel III liquidity coverage ratio (LCR) as of 2015 does not make things any easier if full compliance is implicitly expected already during the monitoring period. The same goes for the net stable funding ratio (NSFR) and leverage ratio.

- Assessments conducted prior to publication of a draft should specifically examine whether
  - the supervisor wishing to issue the regulatory measure actually has the requisite regulatory authority;
  - regulation is actually needed; if the existing rules are considered to be inadequate in a given case, the assessment should explain why and where they are inadequate;
  - the principles of proportionality and materiality are duly taken into account;
  - the new regulation does not result in accounting and banking supervision drifting even further apart and lead to more inconsistencies, duplication or conflicts;
  - the new regulation is sufficiently principles-based.

A regular exchange of views between the Basel Committee on Banking Supervision and the IASB is vital to strengthen mutual understanding of the needs of the different rulemakers.

In addition, more attention should be paid to the principle of proportionality. The **principle of double proportionality** covers, on the one hand, the appropriateness of internal processes established by banks to ensure their risk-bearing capacity and, on the other hand, a qualitative assessment of these processes by supervisors. It must continue to guide regulatory measures. The condition for it to do so is principles-based regulation with some leeway for implementing requirements instead of rules-based standard-setting. Adherence to this principle, through application of suitable methods in each case, creates a diversified banking sector.

Actual implementation of the principle of double proportionality, particularly in the area of operational supervision, is, as we see it, characterised by the following key elements:

- Ensuring individual treatment of banks and thus avoiding uniformity at all costs through benchmarking when assessing compliance with requirements.

- Supervisors should acquire a basic actual understanding of the business of each and every bank and use it pro-actively for their work.
- Conservative elements of risk management should be given greater recognition by supervisors.
- Simplified methods should be allowed on a larger scale for types of risk that play only a minor role at a bank.
- A principles-based approach and assessment should be called for from supervisors and also ensured by supervisors through auditors (reason: heavy pressure on auditors through supervisors).
- An escalation procedure should be set up between banks and supervisors to deal with cases where they disagree over specific requirements. At the same time, communication between supervisors (particularly the Bundesbank and BaFin) should be improved.

4.3 Identified conflicts, inconsistencies and duplication in regulation

We would now like to explore our basic arguments in more depth and highlight some examples of inconsistency in existing and planned regulation. This is by no means an exhaustive list of problems.

4.3.1 Supervision vs. accounting

4.3.1.1 Harmonisation of reporting for regulatory and accounting purposes

As things stand, banks have to meet a number of different – and sometimes overlapping – reporting requirements. The Common Reporting (COREP) requirements for regulatory purposes exist alongside extensive disclosure requirements under Pillar III. **Risk reporting** also forms part of the annual report and, for banks preparing IFRS accounts, further extensive risk disclosure is required under IFRS 7. Steps should be taken to try to integrate and harmonise the various reporting formats. There are a number of overlaps between risk reporting in the annual report and disclosure under Pillar III, for example. Consideration should therefore be given to integrating the two reporting regimes.

4.3.1.2 Accounting definition of trading instruments vs. regulatory trading book

For some time, differences have existed between the definition of trading activities in the accounting sense of the term and the definition of the regulatory trading book. Once again, there would appear to be no good reason for differing definitions, especially since they overlap to a large extent. At first sight, the Trading Book Review currently being undertaken by the Basel Committee on Banking Supervision seems to offer an opportunity to bring about an alignment. But this would involve adopting the so-called valuation-based approach, which is geared towards accounting requirements and has considerable disadvantages from a prudential perspective. With this in mind, the German banking industry has called for the so-called trading evidence-based

approach. This is another area in which banking supervisors and accounting standard-setters should seek convergence.

4.3.1.3 Valuation of assets and liabilities

Banks have to carry out various valuations of their positions for various addressees. These valuations sometimes differ significantly from one another although they are ultimately based on the same data (normally IFRS valuations or valuations under the German Commercial Code [*Handelsgesetzbuch*, HGB]):

- German Commercial Code valuations
- IFRS valuations
- Adjustments of valuations for prudential purposes concerning
  - risk positions (e.g. under Article 100 CRR, prudent valuation and BaFin circular 13/2011)
  - capital definitions (deductions from regulatory capital) and
  - the consideration of expected loss/value adjustments

The EBA's recent discussion paper on prudent valuation is a case in point. The paper contains proposals for applying valuation adjustments for prudential purposes to fair value assets and liabilities in both the trading and banking book. These adjustments would sometimes go far beyond those required for accounting purposes (one example is block trading). It is not clear why a "fair value" in accounting terms cannot be considered a "prudent value" for prudential purposes. If, in some cases, banking supervisors have a legitimate interest in requiring valuation adjustments beyond those calculated for accounting purposes (e.g. for considering the impact of limited market liquidity on concentrated positions), the Basel Committee's Accounting Task Force should seek corresponding adjustments to the relevant IASB and FASB requirements. We consider it a serious mistake to decouple prudential and accounting valuations. A development of this kind has far-reaching adverse internal implications for banks. It risks, for example, establishing a further cycle of monitoring and control of considerably greater complexity which, moreover, could possibly not be implemented without giving rise to inconsistency.

The EBA's proposals represent an unsound approach to calculating and reviewing prudent valuation and would result in a further unnecessary increase in complexity.

4.3.1.4 Calculation of valuation allowances

For no objective reason, different legislative instruments contain different definitions of specific valuation allowances. Under the German Solvency Regulation (*Solvabilitätsverordnung* – SolvV), for instance, they are defined as the valuations in the most recent audited financial statements. By contrast, the German Large Exposure Regulation (*Groß- und Millionenkreditverordnung* – GroMiKV) requires calculations based on current valuations. We believe current valuations should be used for all reporting purposes and also when calculating capital requirements.

4.3.2 Within the supervisory regime

4.3.2.1 Leverage ratio

The requirements of the leverage ratio and the liquidity coverage ratio (LCR) are another example of interaction which has not been adequately considered. The LCR requires banks to hold substantial quantities of liquid assets, but qualifying financial instruments have not been excluded from the calculation of the leverage ratio.

4.3.2.2 Pillar II

- In our experience, banks are permitted less and less discretion as to the methods and techniques they apply with every supervisory review. This is not a desirable development.
- Nor do we believe it serves a useful purpose to require top management to make or authorise more and more decisions concerning minutiae. Accountability for detailed aspects of a bank's risk modelling, for instance, should lie with the responsible unit.
- There is now often an implicit requirement for banks to apply **two parallel ICAAP approaches** (going and gone concern). This flies in the face of banks' freedom to select their own methods. What is more, the cost of applying two approaches is out of all proportion to the benefit thus derived.
- At small banks, where there is normally a high degree of transparency for supervisors, an additional **risk inventory** provides no significant insight and undermines the acceptance of risk controlling.
- The extensive stress tests conducted in the past brought virtually no previously unidentified risk to light at small banks. The results do not justify the personnel and technical resources needed to run the tests.
- For banks with little liquidity maturity transformation, **liquidity requirements** tie up unnecessarily large technical and organisational resources.
- For banks with little **interest rate risk in the banking book**, the requirements for interest rate risk tie up unnecessarily large technical and organisational resources.
- When supervisors review how banks implement requirements, they often focus too much on formalities which say little about banks' actual risk management (e.g. severe penalty because a key to a chart has been omitted although the requirement itself has been correctly implemented).

4.3.2.3 European Market Infrastructure Regulation (EMIR)

Implementing the requirements of EMIR will lead to further inconsistencies. For instance, there is a danger of exacerbating the scarcity of first-class collateral (normally government bonds of countries considered financially stable) because

- CCPs will require more collateral of this kind from market participants and

- more collateral will also be required for derivatives which are not cleared through a CCP: various estimates put the additional demand in the high hundreds of billions to high single-figure trillion range.

The market response will be collateral transformation on a large scale and/or less use of derivatives for hedging purposes.

Other areas which have not been adequately clarified are the interplay with the Basel liquidity coverage ratio (LCR), which also requires large holdings of first-class collateral, and inconsistencies with the US Dodd-Frank Act.

4.3.3 Within the accounting regime

4.3.3.1 Corporate reporting

There are currently a number of initiatives at international level aimed at improving the quality of corporate reporting. One of the approaches under discussion is greater integration of financial and non-financial information in reporting.

Non-financial questions, such as corporate sustainability, and their disclosure have become increasingly important against the backdrop of the financial crisis. We have followed this issue with great interest and actively support sustainable economic activities in terms of corporate governance geared towards the long term and based on ecological, social and economic criteria. Greater integration of financial and non-financial information can help give a clearer picture of a company's long-term performance and contribute to better investment decision-making. Not only investors may find such information helpful, but also creditors, employees and other interested parties. We recognise that there is an international trend towards integrating non-financial information and indicators into company reporting. We support this trend as long as the non-financial aspects reported on are really relevant to the business of the company in question.

Care should nevertheless be taken to ensure that integrated reporting does not lead to a further increase in the scale of disclosures companies are required to make. Proposals are as yet extremely vague on exactly how an integrated report would fit into the existing reporting landscape. Germany, where an extensive management report has long been a feature of corporate reporting, is comparatively well advanced when it comes to reporting on non-financial aspects. One idea worth considering would consequently be to develop the management report into an integrated report. As may be seen by comparing DRS 20 (the German Accounting Standard governing the management report) and the proposals for an integrated report put forward by the International Integrated Reporting Council (IIRC), the management report already covers many of the elements of an integrated report.

The increasing integration of financial and non-financial performance indicators and their relation to company strategy should be seen as an opportunity to move towards more concentrated and focused corporate reporting.

4.3.3.2 Dedicated IFRS for banks

International Financial Reporting Standards apply to all industries and are geared to the various elements of a company's financial statements. The banking industry has a very special business model, however, which cannot always be adequately accommodated by the existing IFRS. On top of that, the links between the accounting and prudential regimes mean that changes or adjustments to an accounting standard, for instance, can often have undesired effects on prudential data.