VERBAND DER
Sparda-Banken e.V.

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The regulatory framework: balancing risk sensitivity, simplicity and comparability

Statement of the Association of Sparda Banks e.V. on the discussion paper of the Basel Committee on Banking Supervision

Introduction

The Association of Sparda Banks e.V. welcomes the initiative by the Basel Committee on Banking Supervision for a debate on capital regulation and the search for a balance between risk sensitivity, simplicity and comparability. We therefore take this opportunity to comment on the discussion paper „The regulatory framework: balancing risk sensitivity, simplicity and comparability“. We welcome this paper as evidence that following the decisive action taken by the Committee during the financial crisis, market participants, as well as the authorities represented in the Committee, now deem it necessary to critically assess and evaluate the Basel framework for potential optimisation.

As the Committee is requesting a review at a time in which the EU measures for its realisation - CRR and CRD - have only recently been adopted and not yet implemented, our comments are not based upon factual experience with the new Basel III capital rules. The Sparda Banks are committed to a comprehensive, timely and consistent implementation of these measures, however note that following future implementation at European level, a further discussion on the content of this paper will be required.

We make our comments from the point of view of a banking group, whose business model stands in stark contrast to those of internationally active, complex banking groups. Sparda Banks rely on the simplicity of their products and corporate structures, enjoying a high degree of stability, steady returns, intensive coverage of local markets and remain largely independent from refinancing on the capital market. This results in a very specific approach towards capital management, which is driven by other requirements than those of international banking models.

From our perspective, the discussion should place particular emphasis on the regulatory framework for internal risk management systems of banks. The fundamental question should be asked whether developing internal models for determining loss expectancy in such intensity as it was the case until the outbreak of the financial crisis was an effective and constructive approach.

It is against this background that generally speaking, we believe the following must apply:

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- All banks must possess sufficient capital and liquidity to cover all their liquidity and default risks at all times.

- This must however be achieved through a differentiated regulatory approach:

    - Complex banking models with risks that are difficult to assess should be subject to stricter requirements. There has been a sharp increase in the complexity of internal risk measurement models approved by regulatory supervisors. For banks using the "advanced approach", additional fixed benchmarks that are easy to interpret must be defined, in order to offset the risk of market and regulatory misinterpretations.

    - Low-risk banking operations need not be subject to the same requirements as capital market orientated, international business models: Straight-forward business models require straight-forward regulation. The existing rules need to adapt more closely to the structures of straight-forward business models than has been previously been the case.

- The regulatory approach of the Basel Committee to focus the main discussion on internationally active banks appears to us to be a systematic mistake. This approach must be re-examined, especially as the European Union has fully adopted the Basel measures into EU-law. Subsequently these measures apply to all EU banks. If in key global regions banks must fulfil the Basel requirements, then in our opinion, the effect on banks of all sizes must be adequately taken into account during the drafting stage. (Please note in particular our comments on Q3 and Q4)

- Regulation should take the economic vitality and competition intensity within the banking markets more strongly into account. Small and medium-sized banks should not be unduly burdened by the BCBS-measures, to the extent that they are no longer competitive enough to retain their positions in the banking system. (See here our remark on Q2)

On the individual questions of the discussion paper, we take following positions:

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Q1. Does the current framework, with its reliance on the risk-based capital at its core, appropriately balance the objectives set out in paragraph 29?

In principle we support the objectives as set out in paragraph 29. In particular, we welcome the shift away from an overemphasis on large, internationally active banks, as well as the implicit commitment to take the risk level of individual business models into greater account when determining their capital requirements. This means that it will be possible to reflect the needs of low-risk business models.

In addition to this, we see it as necessary that group structures play a greater role in the framework design. By helping strengthen and sustain the economy, they have proven themselves to be stabilising pillars for the financial system, stemming from the diversity within the group, which is usually made up of banks of different sizes and varying economic regions.

For this precise reason it would be fatal to continue to work towards a standardised model for measuring capital adequacy based only on the activities of large, international organisations. Rather, greater attention should be paid to the principle of double proportionality in regards to internal steering mechanisms and the intensity of prudential supervision, so that both are given appropriate consideration in the future development of regulatory requirements.

Furthermore, to us it seems that the criteria for to the second (“well-understood measure of capital adequacy“) and third („support a reasonable level playing field between banks“) objectives seem to be off balance: It is apparent, not only from observations of the day to day supervisory practice but also from this discussion paper, that from a regulators’ point of view, monitoring the complexities of the internal risk measurement models, is not fully under control. Both the accuracy of the internal models, as well as the ability to regulate them appears unconvincing.

A logical and at the same time unacceptable consequence of this would be that as studies show there are large discrepancies in the amount of required capital to be held by banks, that have taken the same risks but in different jurisdictions, as in the case of trading exposures. We believe this signals that supervisory authorities are not fully able to retrace the actual mechanism of action of complex risk models, which should be rectified through appropriate measures. (See here further comments for Q.3 and Q.4)

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Q2. Are there other objectives that should be considered in reviewing the international capital adequacy framework?

The new regulatory management of the sector means that all banks are widely affected. Small and medium-sized banks with low-risk business models are however disproportionally impacted upon through the BCBS-rules. New regulatory measures impact differently upon smaller banks compared to large, cross-border banks:

- Employees spend relatively more working hours on regulatory activities in small and medium-sized banks.
- The share of regulation and compliance costs compared to overall costs is higher in small and medium-sized banks.
- The relative ratio of employees in compliance and control departments compared to employees in customer service is worse in small and medium-sized banks.

As a result the competitiveness of smaller banks will not be sufficient to retain their position in the banking system due to increasing regulatory pressures. This means damaging their ability to act as a competitive counterforce to the large, internationally active banks. Overall, this weakens the competitive pressures that these institutes can develop and eventually leads to welfare losses felt throughout the whole of society. In order to reduce these, an optimal balance must be found for competition – not least with a view to a relatively equal supervisory burden. The repercussions of the supervisory and capital requirements rules on the overall competitiveness of the banking sector must therefore also be given special attention when reviewing the Basel regulations.

In light of this, it is of great importance that straight-forward, low-risk business models enjoy greater consideration in the future development of the capital adequacy framework. This means that the differences between business models in relation to their risk orientation must have greater influence on the methodology used for assessing capital requirements, even in the case of standardized approaches.

With the ultimate goal being to create a “level playing field”, this should be embedded as a milestone target. However, initially the priority must perhaps not be to focus on the international level only but first and foremost to review the competitive repercussions of the new capital rules on national banking sectors.

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Q3. To what extent does the current capital framework strike the right balance between simplicity, comparability and risk sensitivity, given the costs and benefits that greater risk sensitivity brings?

1. Comparability

From a European perspective, it is positive that the transnational CRR regulation guarantees, that at least in all EU countries, the same basis is used for the measurement of capital adequacy calculations. Unfortunately this is not the case in regards to other jurisdictions. Whilst the European Union has in principle stayed true to the various proposals of the BCBS and through the implementation of the key provisions as a regulatory act, had an effect on all EU banks, this is not the case elsewhere. This is clearly a competitive disadvantage for the EU banking system.

Furthermore, the question can be raised whether "comparability" even should be labelled as an independent objective, on par with "simplicity" and "risk-sensitivity", which from our point of view are the more important objectives. Strictly speaking, if the supervisory authorities are unanimous on what constitutes simple, risk-sensitive rules then this should automatically result in a comparable rule application. This particularly applies when there is a shift away from the complexity of internal models, which in our opinion, are the main cause for distorted comparability. As correctly identified in the consultation paper, the wide scope used by internal models not only restricts comparisons but also diminishes the confidence of supervisors in the results of these models. In order to counteract this, the range of possible interpretations for the data value adjustments, internal rating class estimates, PDs and LGDs should be restricted. The goal should be that if the underlying risks stay the same, risk-weighted assets should not change over time.

Comparability however also has another, related dimension: The objective must be to strive for comparability of the supervisory and regulatory intensity, not just the regulatory outcomes. The intensity of supervision and regulation must result from a multi-dimensional approach. Therefore the design of risk management processes, governance and complexity of the business model must be central to this. The principle of "same risk - same rules" should not be disregarded, it should however also be reversed: "less risk - less rules".

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2. Simplicity

We very much welcome the demand for simple and straight-forward rules as this reflects our core principles and business model. We believe that low-risk banking business should not be subject to the same demands as highly complex, capital market orientated banking models as straight-forward business models need straight-forward regulation. Small and medium-sized banks should not be disproportionately burdened through regulatory requirements.

The objective “simplicity” based upon the Basel requirements has, at least in Europe, not yet been achieved. The measures resulting from the implementation of Basel III in the form of CRR and CRD are in fact even more complex than previous requirements. In the search for risk-sensitivity, capital standards and in particular the calculation of the capital ratio denominator has become so complex that simplification is necessary. All the more seeing how recent history has proven that:

- Ultimately the complexity of the internal risk models did not help to avoid the crisis.
- Regulators face a situation in which there is an insufficient number of experts who are able to fully comprehend the full details of the internal, risk assessment models.

A simplification is necessary without overly burdening the accuracy of risk measurement. We appreciate the “back to the basics” trend, in which moves are being made towards reducing overly complex requirements. Not just in straight-forward, low-risk banking models but overall there is a fundamental shift back to central risk management basics and simpler risk indicators. In general, the objective must also be to promote the quality of required capital by simplifying the determining factors, with the goal of developing clear and unambiguous definitions to minimise room for interpretation. It would be helpful here to link the calculation base to already existing data from accounting, reporting and risk management for better understanding and traceability.

Simplicity also demands that for very complex or even systemically relevant business areas of banks, as well as the internal processes and systems, there must be easily comprehensible benchmark values that are developed and used as indicators. These should be embedded in Pillar II. It might not be useful to set a leverage ratio as the fixed regulatory maximum value in Pillar I, if the aim is not to create new disincentives for low-risk business that is already relatively disadvantaged. However as a benchmark value in Pillar II, it is worth further consideration.

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3. Risk-sensitivity

From our point of view there is also room for further optimisation in “achieving higher risk-sensitivity”. One example here would be the liquidity requirements, such as the LCR measurements. These for instance only inadequately take into account group and network structures (“Finanzverbünde”), which among other things guarantee a constant supply of liquidity to group members. (See here our remarks on Q1 and Q5)

Q4. Which of the potential ideas outlined in Section 5 offer the greatest potential benefit in terms of improving the balance between the simplicity, comparability and risk sensitivity of the capital adequacy framework?

1. Simplicity as part of the target catalogue

Whilst risk-sensitivity and comparability are already agreed objectives of the BCBS work plan, this does not apply to the demands for simpler rules. The Sparda banks support the criteria “business model appropriate simplicity”, as one of the objectives of the BCBS. Simple capital adequacy requirements appropriate to the relevant business model increase confidence in both the risk management results at banks, as well as in their regulatory audit. This would be a central building block for stability, as investor confidence in regulatory capabilities would increase, which can be a stabilising factor during extreme market situations.

In regard to this, we support the basic principle of the discussion paper, which follows that the internal risk measurement models of many banks did not successfully pass the “real life test” satisfactorily, in spite being based on highly complex, mathematical calculations. This evidence strongly supports the notion to reduce the complexity of internal models.

2. More disclosure

In comparison to the criteria “business model adequate simplicity”, further disclosure would be less effective. Seeing as the disclosure requirements of the FSB “Enhanced Disclosure Task Force” are currently subject to far-reaching discussions, more disclo-

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sure would most likely be seen as excessive to the average investor. It would exceed the capacity of investors if for every bank, market and operational risks, PD and LGD as well as exposure at default information, the entire risk-weighted assets, as well as the average risk-weighting according to asset class, would be made available. The new transparency approach would distort itself to the point that almost no investor would be independently capable of understanding the data portfolio. In addition, as the processed data used by internal models would by far exceed the data which is planned to be disclosed, this would not produce any reliable information regarding the reaction of the internal model on (extreme) market developments. Increased confidence must rather be the result of a reduction in the complexity of internal risk management models and at the same time through the increased expertise of the supervisory review. This should be supported through simpler basic indicators in Pillar II.

We positively note on the other hand, the proposals in the discussion paper to publish information about important risk model decisions, such as changes in the data period for LGD calculations, the assignment of internal ratings to external credit ratings and a cash flow statement, which explains movements in risk-weighted assets. This information is easier to process, yet still provides the market with valuable information on the basic risk techniques of the respective banks. It also helps to assess the risk culture and risk appetite over a course of time. It would therefore be ideal to supplement this information with the publication of a comparison between modelled and standardised capital calculations. We would see it as helpful if organisations with their own risk management models would have to also complete and disclose calculations using the standardised approach for operational risks.

3. Using additional metrics

From a European perspective, it is of particular concern, that during the implementation phase of Basel III through CRR/CRD IV, doubts are being raised about the measurements of the existing metrics. If the Task Force does not view the proposed measures to be implemented as suitable risk indicators, then it cannot be beneficial to add new indicators: Instead those intended for implementation should be optimised and simplified. Anything else would be contradictory to the commitment of simplifying.

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4. Restriction of national distrection

In principle we support the idea to restrict national discretion, as it can reduce distortion in competition at an international level. In the supervisory discussions, demands for national discretion are often made in order to retain (successful) specificities of the national banking markets. These are commonly linked to small and medium-sized banks, which were not and are not the focus of the BCBS. In light of this, the call for national discretion is understandable and appropriate, as it counteracts and corrects the one-sided overemphasis on internationally active large banks in the Basel rules.

Before national discretion can be given up, the Committee therefore must find a way to allow for equal treatment towards small and middle-sized banks. This demands reducing the “one size fits all” approach. Consequently, further consideration must be given to the risk appropriate treatment of straight-forward, simple banking models than has been the case to date.

We also welcome the requirement for an exercised discretion database. In particular we think that examining the consistency and uniformity of “relevant supervisory practices”, is useful. The rules should be applied equally and proportionately in all countries.

5. Increase effectiveness of leverage ratio

Due to the reasons mentioned above (see Q.3, “simplicity”), we do not see any necessity to establish a leverage ratio under Pillar I. We can also not see any real value for a quantative indicator as a “buffer” that would establish the leverage ratio under Pillar I.

Above all, the main argument against establishing a leverage ratio under Pillar I is that not only quantative but also qualitative criteria must play an important role in the assessment of debt relating to risk positions and in particular the risk content of the relevant balance sheet items. Importance must be given to the degrees of diversity between risk positions. This would not be possible in the case of a maximum leverage ratio. These aspects support our position that the leverage ratio should at most be at most embedded under Pillar II. The basic approach should be to give priority to simple calculation models for capital adequacy that however sufficiently take the actual risk

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situation into account. To use comparability as a possible assessment objective for such a model is from our point of view not useful.

6. Simple, alternative capital requirements

We feel that the introduction of simpler, alternative capital requirements needs to be examined closer. However, these should not be established in addition to already existing indicators; rather they should replace and be used exclusively as an alternative to the current requirements. Otherwise even if alternative approaches would be more straight-forward to implement, the overall regulatory requirements will become more complicated. The objective should be to provide institutes with a catalogue of clearly structured requirements that can be implemented with a manageable effort. This would enable the establishment of one simple method for the realisation of the basic regulatory principles, appropriate for the core banking business activities.

Q5. Are there other ideas & approaches that the Committee should consider?

- **Disadvantages for retail-orientated banks**
  - **Interest rate risks in the banking book:** The increase in retail bank requirements for liable capital and the interaction with the standardised interest rate shock, which is simulated through a parallel shift of the interest rate of 200 base points each way, leads to massive restrictions in the business models of retail banks. This loses sight of the main causes of the financial market crisis. One main consequence would be that economically speaking, it would not be possible to offer long term fixed interest rate loans. In effect this could even go as far as creating conditions similar to those that caused the financial crisis.
  - **Risk-weighting for retail and real estate business**: We see it as wrong to view risk-weighting calculations as an opportunity to counteract the overburdening of debt for individuals and price bubbles on the property market, as this does not take regional differences into account. In order to counteract these risks, regional and more individually tailored measures and procedures must be utilised. This particularly includes the requirements for determining mortgage lending values. The 75% and 25 % lump sum, unmodified risk weighting

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for retail and real estate business (alongside “compensatory” risk weighting reduction for SME-credits) must be urgently reviewed.

- **Review of liquidity requirements:** Aside from the capital requirements, the new Basel liquidity regime with its regulatory liquidity calculation indicators should be subject to an equally thorough review.

- **Regulatory reporting:** In order to achieve the objective “simplicity” more effectively, it is equally vital to critically asses the demands made on regulatory reporting in banking which have sharply risen. The volume of data that must be reported on has significantly increased which has not led to a simplification, rather the opposite. We advocate undertaking a critical evaluation of the standards introduced through COREP in Europe in regards to their volume with the aim of simplifying and streamline processes. This should happen at the Basel Committee level with the objective of moving forward in a unison and realistic manner.

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About the Sparda-Bank group

Sparda-Bank, the business community that makes banking business fair and easy.

fair — We offer our customers good value for money.

The region is our market. Therefore, we stand for:

- Performance and prices should not be standardised or legally regulated.
- We accept the competition with providers from throughout the EU single market however demand fair competitive conditions.
- Together with our members, we do not would to be liable for the risks taken by others, whether in Germany or in Europe. This also applies to our cooperative system for investment and institution safeguards.

uncomplicated + effective — We don't do everything, but what we do we do simply and really well.

Our business model and products are straightforward, transparent, low in risk and largely independent of the capital market. Therefore we stand for:

- Straightforward business models require straightforward regulation.
- Small and medium-sized banks should not be disproportionately burdened.
- Low-risk banking business does not need to be subjected to the same demands as speculative capital market actors.

caring — With us everyone feels well taken care of.

In Germany, the Sparda banks set the benchmark for customer satisfaction. Therefore we stand for:

- A relationship of trust with the customer is the basis for practical consumer protection. For us the conversation with customers is the most important contact.
- Formal requirements, documentation- and monitoring obligations are not allowed to overshadow the relationship with the customer.

cooperative — We are the bank that belongs to its members.

We live the ideas and values of the cooperative in the purest form. Therefore we stand for:

- The cooperative sector must be supported and maintained as a stable pillar of of a diversified banking structure.
- Banking regulation should not hinder or even render the operation of a bank as a cooperative impossible.
- The cooperative associations of banks should not be discriminated against in contrast to corporate structures.

The Sparda banks group consists of twelve economically and legally independent institutions and several service companies such as the Sparda data processing eG and Sparda Consult for Project and Innovation Management GmbH. With over 3.41 million members and approximately four million customers the Sparda banks are among the largest retail banks in Germany. The Sparda banks, as cooperative banks, are members of the Federal Association of German Cooperative Banks (BVR) and part of the German co-operative FinancialGroup.