German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

On the BCBS Discussion Paper “The regulatory framework: balancing risk-sensitivity, simplicity and comparability“.

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On 08 July 2013, the Basel Committee for Banking Supervision (BCBS) published its Discussion Paper "The regulatory Framework: balancing risk-sensitivity, simplicity and comparability". This Paper seeks to facilitate a discussion of ideas for a more balanced approach reconciling the partly contradictory Basel objectives of risk-sensitivity, simplicity and comparability thus overcoming needless complexity in the Basel Standards and enhancing comparability. During this exercise, from our point of view, the framework's risk-sensitivity should possibly be maintained or, potentially, should even be further strengthened. We appreciate the present opportunity to submit our comments.

We should like to preface our comments by pointing out that the German Banking Industry Committee represents a highly heterogeneous community of banks featuring an extremely large variety of sizes. Our members range from regional players, i.e. banks with ten members of staff to global players listed on the stock exchange featuring one hundred thousand full-time employees. Owed to this circumstance allow us to occasionally advocate in favour of differentiated standardised approaches for small and medium-sized banks; in other words, there should be a multi-tier treatment. Having said this, the German Banking Industry Committee is consistently in favour of protecting the risk-sensitivity of all approaches alike. Risk-sensitivity should be maintained for all approaches by following a hierarchy ranging from standardised approaches to advanced approaches. Our main rationale for this approach is providing a modular toolkit from which those regulatory requirements and calculation methods can be chosen which are respectively most appropriate to the specific constellation, i.e. it can be applied in a modular and evolutionary manner both to local players and to international financial institutions thus accommodating banks' respective idiosyncrasies.

Furthermore, we should like to point out that we explicitly welcome the opportunity to share our views. In many regards, the host of new regulatory projects has exhausted banks' resources nearly to the limit. We subscribe to the Basel Committee's fundamental view that, over time, the complexity inherent in the Basel Framework has seen a constant increase. Furthermore, in recent years there has been an exponential rise in the scope and interdependency of the requirements thus further compounding the rules' complexity. We endorse the Basel Committee endeavours aimed at enhancing the comparabiltiy and the trustworthiness of the risk based Basel ratios as well as simplifying the framework in general.

In its 2004 Basel II framework agreement entitled "International Convergence of Capital Measurement and Capital Standards", the Basel Committee commented on the rationale underlying the Basel Accord as follows (cf. Indent 9): "It should be stressed that the revised Framework is designed to establish minimum levels of capital for internationally active banks." In this regard, we welcome the current plans of designing the Basel Framework in a way that also caters to the situation of smaller and medium-sized banks in an adequate manner. Due to the fact that the EU legislation is geared strongly towards the Basel requirements whilst, at the same time, however, these requirements shall be applicable to all European banks, this is of particular importance for European Banks. The presence of a differentiated set of rules is also the best prevention of conflicts with the analyses of the Standards Implementation Group. We recognise that these considerations already take on a considerable dimension, for instance during the redefinition of the market risk standardised approach as part of the trading book review.

To date, the increasing regulatory requirements are accompanied by a level of complexity that is especially unmanageable for banks which are not international players. However, the complexity of the requirements is hardly fathomable let alone manageable even for larger banks. Hence, we recommend that the forthcoming Basel Committee drafts explicitly include differentiated rules for banks without capital market debt financing and smaller banks (e.g. during the reform of market risk rules this could be implemented by way of standardised approaches featuring two different degrees of complexity). This could either be designed as separate rules or it may come in the form of a multi-tier approach where the rules with the lowest level of complexity will be applicable to smaller banks and the highest tier of complexity rules will be geared towards internationally active banks.

In our preliminary understanding, the "Task force on simplicity and comparability" received the mandate to identify ways in which complexity can be reduced and to enhance comparability of the regulatory framework (without sacrificing the respective level of risk-sensitivity) Unfortunately, the Paper only focuses in an insufficient manner on the advantages inherent in risk-sensitivity whilst, on the other hand, it appears to underestimate the disadvantages of less sophisticated, less risk-sensitive standardised approaches which are suitable at best for smaller banks featuring a simple risk structure. Hence, we would like to encourage the Committee to uphold the principle that supervisory rules have to be risk-sensitive by nature and that capital-based incentives should be conceived of in a way that banks have an own interest for using advanced approaches.

Hence, in order to facilitate a smooth transition, we would welcome it if the future rules were designed in a way that allows an easier modular migration from simple approaches (which work on the basis of generic / fixed indicators and risk weights) to advanced approaches featuring heuristic elements to internal models which have been approved for regulatory purposes. This modular use would, for instance, not require that in every case the entire affected portfolio (e.g. in the market risk area) migrate to an internal approach but would allow more flexible sub-portfolio approaches (e.g. F-IRBA in retail banking). As a result, this would at the same time address the issue of banks being forced into internal approaches, for instance, despite larger problems in the data availability or when capturing risk factors. Furthermore, we would like to point out that, in some parts, the risk-based system currently also lacks a sufficient degree of risk-sensitivity; for instance, this applies to the treatment of government bonds. Whenever shortcomings in the risk-based system have been detected, they should be remedied in the medium-term by means of direct reforms of the risk-based standards; by no means should these shortcomings be used as an opportunity to introduce capital adequacy requirements through a Leverage Ratio. Direct reforms also facilitate an appropriate capital buffer.

Whilst the Task Force embraces the view that (Indent 3) risk-based capital requirements shall remain the centrepiece of the regulatory framework, in our preliminary understanding, this is a clear rejection of a regime which is exclusively based on capital requirements that are not risk-sensitive. We strongly endorse the attitude thus expressed, i.e. that a Leverage Ratio shall only be included in the regulatory framework in a supporting capacity, i.e. as a so-called backstop. This basic guiding principle should also be upheld in future. However, the subsequent ideas spelt out in the present Consultation Paper (addressing factors driving complexity in a more fundamental manner) seem to undermine this. The

Leverage Ratio affects banks in the most diverse ways. Hence, we still hold the view that it is not useful to cover the treatment of the Leverage Ratio in Pillar I.

The material objectives of the regulatory requirements specified in the present Discussion Paper involve major tradeoffs which are also highlighted in the Discussion Paper. For instance, enhanced risk-sensitivity usually increases complexity. Increasing complexity, however, may either enhance comparability or come at the cost of comparability. For instance, if a simple standardised approach such as the credit risk approach becomes more risk-sensitive and thus, generally more complex (e.g. due to an increase in the number of asset classes which are subject to differentiated own funds requirements) this may improve the comparability of the calculated own funds requirements. Based on the above, as a strategic task it would indeed be conceivable that the standardised approaches be subjected to a critical audit in order to enhance their risks sensitivity and thus the comparability of the results obtained. With regard e.g. to the Credit Risk Standardised Approach or Standardised Approach, this seems to be one of the ideas indeed informing the ongoing review.

The envisaged comparability presupposes a minimum degree of risk-sensitivity. For instance, this is not the case with regard to the Leverage Ratio. Whilst the usefulness of a comparison between banks on the basis of the Basel I Standardised Approach is quite rightly being called into question (cf. Indent 28) this applies even more so to the Leverage Ratio. As far as its “comparability” is concerned, the Leverage Ratio has to be regarded as a complete failure. It is widely known that banks featuring entirely different risk profiles may have identical Leverage Ratios.

However the Task Force remains vague with regard to the future policy for handling tradeoffs. A legally binding audit of standards with a view to their simplicity, comparability and risk-sensitivity would merely create transparency at this juncture. The future handling of tradeoffs remains unclear. It will only be possible if there is a prioritisation / establishment of a hierarchy for these three goals. In our view, they cannot be regarded as equally important. At this juncture, the risk-sensitivity should come first since it is the prime objective underlying the steering framework. This is required in order to avoid erroneous steering incentives as well as regulatory arbitrage. The comparability objective should come second in the hierarchy of objectives. This is required in order to ensure the acceptance of the framework. At this juncture, securing the comparability is the joint steering task of the BCBS and of the national supervisory and financial authorities. Last but not least, the goal of simplicity should serve as a guiding principle or, moreover, a binding secondary condition which ought to be taken into account during every regulation. So, in doubtful cases where it is difficult to decide between two alternatives, there should always be a decision in favour of the more simple approach.

Although this might admittedly result in a considerable reduction in complexity, in our view, the realignment shall and may not abrogate the model-based own fund requirement. Rather, an appropriate realignment of the Basel Committee’s work must also focus extensively on efficient action aimed at regaining confidence in internal models and model-based capital requirements. We have strong reservations over the fact that this sub-aspect in the strategic realignment is absent from the present

Discussion Paper. At best, it is addressed in an indirect or rather, implicit manner; there is no specific mention of this vital sub-aspect.

This is not only a task incumbent upon the banking industry but also upon the supervisor: With regard to the maligned variability in the level of the calculated regulatory capital requirements, the significance of divergent national requirements (for instance in the context of the approval process multipliers, add-ons etc.) is at least *on a par* with banks’ diverging model approaches. What is more, an attempt at obtaining zero variability would be just as counterproductive. Model approaches inherently feature a certain bandwidth in terms of their results. This is by no means a source for concern. This bandwidth must be preserved due to the fact that anything else would erode the fitness for internal purposes. Instead of aiming for a zero variability, it would be worth considering the possibility of the Basel Committee specifying an order of magnitude for the desired bandwidth which would be acceptable across different banks and which – similar to the studies already conducted by the SIG BB and the SIG TB – would be subject to regular reviews.

Hence, in particular for the purposes of regaining trust in internal models, we see the following options:

a. Standardisation options aimed at reducing the variability of model results possibly without jeopardising the fitness for internal model purposes. As a matter of principle, all considerations should be informed by the understanding that guidelines instead of features be stipulated for the various models. As long as there is compliance with these guidelines, banks should be free to design their modelling.
b. More flexibility in the choice between the standardised approach and model alternatives under the IRBA:
   - No mandatory roll-out of the IRBA also to portfolios pushing the limits of modelling
   - Flexibility in the use of the F-IRBA and the A-IRBA (e.g. no compulsory use of LGD-estimates in the sovereign portfolio in the A-IRBA)
   - No compulsory use of the IRBA for “small” portfolios (generally owed to problems with regard to data availability)
   - No inflexible definition of an excessively comprehensive scope of IRBA processes (e.g. as is the case in Germany)

c. Improvement of transparency concerning the model approach and the model results

d. Highlighting positive developments by means of trading book reviews (e.g. desk approach)

e. Strengthening the use test philosophy (reversal of the present trend which can be observed particularly in the field of market price risk)

f. Comprehensive model validation approach beyond mere quantitative back testing, potentially further guidance by the Basel Committee

g. Setting up an independent Model Committee within banks (below a Risk Committee) for portfolios where the models generate questionable results (e.g. for certain complex securitisation portfolios),

Specific comments on the proposals aimed at reducing complexity and enhancing comparability

1. Explicitly recognising simplicity as an additional objective

On principle, we welcome the explicit inclusion of the objective "simplicity“ in the BCBS mission statement. However, we hold the view that, in its capacity as a counterpart to “simplicity”, “complexity” needs to be broken down further: On the one hand there is the complexity which results from a host of interdependent rules and regulations and on the other hand there is the model-based complexity which can hardly be avoided unless internal models are to lose their fitness for internal purposes. Hence, as far as we are concerned, there is an **undesired complexity** which needs to be eradicated and that results from a level of regulatory intensity that is partly so strong that the associated implementation costs appear at least questionable with regard to the principle of proportionality; on the other hand, there is a kind of "**positive”** complexity which enhances risk-sensitivity and is a *conditio sine qua non* as well as an explicit *desideratum* with regard to model validity.

The **undesired complexity** results from an (excessive) diversity or, moreover, host of rules and regulations which banks need to comply with; it is also due to the mutual interdependencies of these requirements. Such complexity is marked by a decision-making situation which cannot be structured (the host of interdependencies does not lend itself to a systematic approach). As a result, the adequacy of decisions can no longer be validated on the basis of banks’ usual internal targets. Furthermore, the possibility arises that a complex regulatory architecture is conducive to a decision concerning individual bank objectives, whilst at the same time proving an obstacle towards other objectives (trade-offs, dilemmas). In the meantime, the new regulatory architecture has become so complex even for regulators that the aggregate impact as well as the interdependencies can no longer be fully gauged. This situation is further compounded by the fact that regulatory frameworks have become so complex that the bank frequently has major difficulties in maintaining a clear idea of the sheer plethora of existing supervisory requirements, which of these are relevant for the bank and whether its translation into operational processes is taking place in an adequate manner.

The transposition of the Basel rules into European legislation was followed by their transposition into national prudential supervision law as well as the implementation of these requirements within corporate entities. During this process it became clear, that the complexity and scope of the requirements increases with every echelon of the regulatory hierarchy. A glance at the European level is sufficient evidence for this point: There are comprehensive rules and regulations under the CRD IV, CRR as well as concomitant Technical Standards (RTS / ITS) and explanatory Guidelines of the European Banking Authority (EBA) which need to be taken into account.

As a result, the respective downstream functions have to face an increased implementation burden. However, also the implementation measures become more susceptible to errors. Initially, with regard to

first-time implementation, afterwards with regard to the ongoing operation of the implemented provisions, supervised entities at the lowest hierarchical level of obliged entities have to face a spate of supervisory requirements along with the associated considerable costs.

In the final analysis, the complexity of the acquis incurs legal uncertainty for banks. The risk of an erroneous and thus inadequate implementation of supervisory rules should not be underestimated. As a result, banks may have to face supervisory interventions, e.g. in the form of capital charges thus incurring further costs. On the whole, the standards' complexity erodes the official agenda in this context, i.e. strengthening an effective and risk-sensitive capital adequacy framework for banks.

Hence, we explicitly welcome the proposal by the Basel Committee i.e. including simplicity as an integral part of the agenda during the Committee's forthcoming standard-setting process. However, this should not only be part of the agenda of the Basel Committee's various working groups but the onus is also incumbent upon the obliged entities in charge of implementing the forthcoming standards - e.g. the European Commission, Member States but also the European and national supervisory authorities if and when they have a standard-setter mandate.

In the light of the above trade-offs there is a clear need for reduced complexity. Complexity increases (declines) due to an increase (reduction) in the number of requirements and/or due to additional (less) interdependencies between the requirements. This is not a linear process. If such a kind of reduction results impossible, the supervisor should at least ensure that potential inconsistencies and interdependencies hitherto ignored will be subject to an in-depth *ex ante* analysis.

It is worth noting that the regulatory complexity within the above meaning is conceptually different from the *de facto* visible **complexity of internal models.** The internal use and supervisory use of complex mathematical statistical models result in an increasing number of model risks; this is by no means an expression of increasing regulatory complexity. This type of complexity typically arises as an appropriate reaction on the part of model developers to respective financial market trends (e.g. product innovations in the derivatives area or in the area of securitisations) which will have to be taken into account during the model development. In the absence of an adequate reflection of such changes, models would be outdated within but a short period of time meaning that they would no longer be fit for purpose when it comes e.g. to internal risk management. However, it makes sense that the fitness for purpose with regard to the internal use be also linked to the fitness for purpose with regard to supervisory use (use-test). Hence, trying to remedy this type of complexity by an abolition of the models for supervisory purposes would be unproductive. Banks' operational risks can only be captured to a limited extent by supervisory standardised approaches or regulatory approaches that are not risk-sensitive (e.g. the Leverage Ratio); also, their compatibility with banks' internal incentive structure is limited. If supervisors abandoned using internal models for supervisory purposes they would merely turn a blind eye on the complexity of financial markets. What is more, such an approach would also lead to dangerous incentives for the wrong behaviour.

In the light of the above, the consideration of simplicity in the regulation should not come at the expense of the necessary risk-sensitivity. Especially the creation of “good enough models” with partly prescriptive elements (e.g. imposing limits on diversification) that draws on a spectrum of approaches allowing a development towards internal models without prescriptive elements would be fit for purpose when it comes to facilitating a balanced relationship of risk-sensitivitiy and the requisite (model) complexity.

2. Enhancing disclosure

At this point, we should like to highlight once more that we represent the interests of banks featuring different sizes. Hence, we would like to express two different objectives which, from our point of view, are equally important. Our associations’ small and medium-sized member banks hope that compliance with forthcoming disclosure requirements will not incur any additional costs which would not be offset by any tangible value added; our large member banks, on the other hand, seek to tap the synergies inherent in the interfaces between supervisory reporting and local GAAP reporting whilst, at the same time, trying to avoid duplication of work.

At present, banks need to comply with a wide variety of partly overlapping disclosure requirements. Along with the comprehensive disclosure requirements under Pillar III, there are risk reporting requirements as part of the (group-) management report under national law as well as under IAS 1 and IFRS 7. These diverging reporting formats should be harmonised and integrated. For instance, a host of overlapping areas exist between the risk reporting as part of the management report and under Pillar III meaning that it might make sense to integrate both reporting systems. One necessary precondition for this is the use of standard definitions.

One way to reduce the complexity would be tackling the issue of different consolidation scopes for the purposes of supervisory consolidation and accounting consolidation. This could already result in inconsistencies between the disclosure obligations under Pillar III and the risk reporting under national law and IFRS 7. Any forthcoming integration of both reporting systems (which would be our preferred choice) would have to resolve this problem, too.

Based on the foregoing and on a more general note, we would like to point out that the disclosure of (supervisory) reporting schemes is not necessarily fit for purpose when it comes to the information of a broader public. This is due to the fact that the underlying concepts are but difficult to understand for the Addressees of the information. The problem for readers of annual financial statements and the information disclosed under Pillar III does not exist in the fact that there is not enough information. Rather they struggle with the intelligibility or, moreover, lack of frame of reference for the information obtained. The intelligibility is further impaired due to the sheer volume of information.

Section 5 discusses ways of improving the disclosure. This section *inter alia* contains the proposal to disclose even further information which goes beyond the current *status quo.* Due to the fact that the disclosure under Pillar III is fairly comprehensive already today, this proposal should not lose sight of the

fact that the higher information content should not come at the cost of disclosure reports’ transparency and readability. Furthermore, there should be an ongoing review whether existing disclosure requirements may be revoked again given their cost-benefit ratio. An excessive level of detail might lead to an information overload for market participants. As a result, they would have to go to great lengths in order to filter useful information from irrelevant information. Alternatively, they might be sheer overwhelmed by the wealth of data. As a consequence, the disclosure obligations should focus more on material and relevant information in a comprehensive and consistent format.

For instance, the same can be said regarding the gain in decision-useful information which results from the extended disclosures in the reporting templates under Basel III. Also here, we suggest an ongoing review whether reporting requirements cannot possibly be taken back again or, moreover, to which extent the reporting intervals for relatively stable components could be harmonised with the Pillar III disclosure interval.

During any future disclosure of calculations based on standardised approaches (e.g. in the market risk area or in the credit risk area) supervisors should make it clear that the reliability and comparability of the results obtained by means of standardised approaches do not necessarily have to be superior to those of internal models. Due to risk capturing problems – e.g. with regard to basis risks – less risk-sensitive standardised approaches may clearly exaggerate or underestimate actual risks. Hence, deltas between the results which may have been calculated internally and those which are subject to the use of a standardised approach for supervisory purposes need to have a sound rationale and ought to be enhanced by means of respective explanations in order to be easily interpreted by third parties.

Without prejudice to these considerations, on behalf of our small and medium-sized member banks, we would like to point out that the Consultation Paper fails to comply with its declared goal *ex ante*; this is due to the fact that the disclosure requirements are being extended and not reduced. Hence, we object to the extension proposals particularly for the additional reporting templates as well as the calculation and the disclosure of benchmark portfolios. We would like to point out that for large banks already today the scope and complexity of the regulatory framework is hardly feasible any more. Hence, for banks, compliance with the transparency requirements is an operational risk in its own right. Last but not least, there is a basic principle (i.e. the protection of business and trading secrets) which warrants general caution and a conservative approach with regard to the proposed disclosure of individual model validation reports.

The current proposals seek to facilitate a disclosure that provides decision-useful information for readers of financial reports which will have a disciplining effect on individual banks and a stabilising effect for the financial system as a whole. In view of the criticism raised, the current proposals fail to deliver these objectives. The various stakeholders incur costs: Banks (production), counterparties (acquisition of specialist knowledge) and supervisors (control). These costs bear no relation to the potential benefit.

In February and August 2013, the EBA carried out RWA consistency tests on credit risk; in January 2013, the BCBS published an analysis for the market price risk. In view of the respective results, a renewed

extension of the disclosure obligations seems imminent. Potentially, these forthcoming disclosure requirements even exceed the extensions proposed in the Discussion Paper for the purposes of a simplification of the Basel Framework. Hence, any extension and tightening of the existing disclosure rules should be postponed until there has been a verification by banking supervisors in cooperation with the affected stakeholders (banking community, investors, analysts, rating agencies and accounting standard setters) of the current concept for market discipline and of the rules and regulations which build on this.

3. Using additional metrics.

The Discussion Paper presents a range of ratios which might be used for assessing the solvency of the banks under observation. This is regarded as a remedy for excessive reliance on one single ratio. Whilst, on principle, we comprehend the rationale behind this proposal, at the same time, a “set of metrics” should not lead to a random use of these ratios. It needs to be clear that these broader sets of metrics are not equally valuable, quite on the contrary. Hence, empirical analyses of the Research Task Force would be helpful in order to better assess the ratios for instance with regard to their univariate or multivariate discriminatory power concerning the insolvency forecast of banks. Access to available informations which have proven their reliability and discriminatory power such as the ratios used in internal rating approaches when rating exposures to banks could be useful.

Furthermore, we would like to point out that, especially from the point of view of smaller and medium-sized banks, an increasing number of ratios only appears useful if a) there is hard and fast evidence that this leads to information that is useful for the supervisor and b) if this does not incur any unreasonable extra costs. Additional metrics may also come at the expense of simplicity and comparability. For instance, the comparability might be jeopardised by input parameters which are based on diverging accounting standards. Also, additional metrics might confuse readers. This is due to the fact that these readers may not know which one is the most meaningful metric with regard to a bank’s capital adequacy.

Any introduction of new ratios (such as the ratio of non-performing assets to the total assets) should therefore always refrain from introducing new definitions. Basel III or, moreover, the EU in the form of the CRR / CRD IV already provide a rich toolkit for these purposes. For instance, under Basel II, clear default criteria are defined for non-performing exposures which could be used when defining the level of the non-performing assets and thus the calculation of these ratios.

On principle, metrics used for the assessment of banks’ solvency should be largely independent of the share price. This is due to the fact that it is theoretically vulnerable to so-called herding or campaigns by individual market participants. The ensuing volatility would prevent sustainable steering information. Banks would be forced to make their capital allocation decisions on tactical grounds instead of adopting a strategic approach. By way of analogy, also mark-to-market accounting is not useful for assets held on a long-term basis.

4. Ensuring the effectiveness of the Leverage Ratio

We feel that it is not possible to compare the solvency ratio of various banks on the basis of the Leverage Ratio. Every comparison presupposes ratios that feature a certain minimum degree of risk-sensitivity. This is not the case with regard to the Leverage Ratio. Whilst the usefulness of a comparison between banks on the basis of the Basel I Standardised Approach is quite rightly being called into question (cf. Indent 28) this applies even more so to the Leverage Ratio. In order to avoid such misunderstandings, we hold the view that the Committee should vigorously debunk such theories.

Empirical investigations into the question as to which extent the Leverage Ratio can be seen as a statistically univariate ratio with discriminatory power for identifying banks which can operate as going concerns and those which become insolvent provide mixed results. Yet, those studies which propose the Leverage Ratio as an incisive ratio ignore the possibility that their results might only be significant due to the fact that the Leverage Ratio is currently not being used as a control parameter. The use for regulatory purposes might impair the Leverage Ratio’s discriminatory power. This might be due to an increasing focus on management purposes (cf. Goodharts Law).

In our view, however, there are just as many empirical surveys which do not assume that it is an indicator with discriminatory power. After all, more often than not, there is no proof of a discriminatory power. From an economic point of view, there is also an explanation for this. After all, the Leverage Ratio is a vertical ratio belonging to the liabilities side. This sets it clearly apart from a horizontal ratio for the risk bearing capacity during banking operations where loss sources (causes for insolvency) which are primarily to be found on the asset side of the balance sheet, are juxtaposed with a loss absorption measure (equity). However, this information] is provided by the ratios "CET 1 Coefficient” or “Core Capital Coefficient”.

Under Indent 59, similar to the structure of the risk-based regulation, the Discussion Paper submits to the discussion its proposals for a “buffer” structure as well as the inclusion of stronger leverage ratio requirements for G-SIBs. We do not think that this is a useful idea. We have the same reservations over potential plans to break the Leverage Ratio down on the basis of different risk profiles (which *de facto* translates into the introduction of risk weights for the Leverage Ratio). In the final analysis, all ideas mentioned emulate the existing risk-based standards whilst, however, delivering considerably less value added information than these existing risk-based standards. As a result, also the definition will become ever more complex. In our view, the proposals are incompatible with the character of a Leverage Ratio as a backstop measure. Hence, in their capacity as approaches they seem to erode the frontstop character of the risk-based standards. We strongly object to this. Instead, one alternative choice the BCBS might consider would be leaving the Leverage as a Pillar II instrument on a permanent basis.

Also, the goal of "simplicity“ is not achieved by means of a Leverage Ratio. Upon closer analysis, the definition of the Leverage Ratio (let alone the calibration) on its own is already excessively complex. Furthermore, in this context it is worth noting the extension of the supervisory consolidation scope to

interests in financial sector entities which are not deducted from capital for the purposes of the risk measure.

A number of issues are not resolved (not even by the draft modified definition which, at present, is equally the subject of a Consultation Round). This particularly applies to the issue of diverging accounting standards. What is more, the Leverage Ratio is by no means "model free": For instance the mark-to-model measurement of derivatives partly requires highly complex valuation models or potentially even simulation approaches. On a more general note, this more or less applies to all on-balance sheet valuation amounts. However, within this meaning, the Leverage Ratio itself can be viewed as a rudimentary and wrong model for reflecting a bank's operational risks. Hence, even the Leverage Ratio cannot claim to be a simple, robust rule. In this respect, please cf. also the GBIC Comment Letter on the Basel Modification of the Leverage Ratio.

The complexity of the rules (particularly when it comes to the calculation of the RWA) jeopardises the establishment of an appropriate balance between the complementary goals of risk-sensitivity, simplicity and comparability. Strictly speaking, championing a leverage ratio that lacks risks weights as an allegedly superior metric would actually render the Basel Committee's declared objective (i.e. establishing more risk adequate own fund requirements) nil and void.

5. Utilising added floors and benchmarks to mitigate the consequences of complexity

In our opinion, also in future, during all regulatory projects for all banks risk based capital adequacy standards should be priority number one; having said this, model based capital requirements are naturally of greater importance for larger banks. This also includes preserving a framework of a capital-based incentive structure for adopting the advanced approaches. Should additional floors be used, their threshold should by no means be defined in a way that they will always become applicable in the practical application. Such an approach would constitute a *de facto* abrogation of the risk-based approaches. It would also be an extremely strong disincentive for further development of internal models. Hence, we object to such an approach. After all, internal models would lose their relevance for business decisions. Yet, standardised approaches, on the other hand, feature certain deficits with regard to the quality of their risk measurement for larger banks. Yet, under the current proposals] they would gain in importance for decisions regarding banking operations. We strongly doubt that this is in keeping with supervisors intents and purposes or, moreover, financial stability. At this point, we would like to explicitly emphasise that the objective of risk-sensitivity should be given priority and that floors should always be designed in a way that is time variable. This will allow a gradual roll-back of any corresponding backstop effect in line with growing evidence for the models' validity.

Standardised approaches are based on clear simplifications concerning the risk measurement; more often than not, they lead to excessive presentations of risks or understatements of risks. Hence, on their own, they are not sufficient for designing appropriate capital adequacy requirements. Standardised approaches should serve as a temporary back stop regime when new model-based approaches are introduced. As a

permanent floor for model-based approaches they would mean a bare capital add-on which cannot be accepted.

Whilst it may be correct that floors can reduce the variability of model results, the price for this is clearly and solely risk-sensitivity and does not enhance the comparability, either. We also doubt that floors make a contribution towards simplifying the regulatory framework if banks always carry out a parallel calculation of internal models and standardised approaches and additionally have to steer compliance with the floor. Furthermore, the introduction of further floors would clearly reduce banks’ incentives for a further development of their risk measurement approaches. However, precisely this promotion of improved risk measurement and risk management which is being hindered by the current proposals is part and parcel of the Basel Framework (c.f. the Basel Framework’s primary aims summarised under Indent 29). *Vice versa,* banks which, in the past, invested extensively into their risk measurement could suffer *ex post* disadvantages upon introducing binding floors.

In effect, when it comes to delivering the discussed aims, floors fail in every respect. They are *de facto* rough add-ons on calibrated, risk-based capital requirements. Hence, they are hardly an appropriate tool for improving confidence into regulatory ratios and cannot be accepted as a permanent measure.

Should, notwithstanding the foregoing, floors play a larger role than to date, as a minimum these floors will have to be sufficiently risk-sensitive. For instance, with regard to the LGD floors, this could be achieved by factoring in Loan-to-Value (LTV) considerations (the lower the LTV, the lower the floor, or, moreover, below a LTV threshold floor the definition of which is still pending, the floor will equal zero). During such deliberations, it has to be clear that, as a general rule, floors should be conceived in a way that is compatible with the incentives. For instance, a floor of 90% is hardly capable of justifying the additional costs of an internal model. This is due to the fact that they are hardly offset by a corresponding degree of savings in terms of their regulatory capital requirements. Furthermore, depending on the context, in every case it should be ensured that adverse past events do not define the floor for the future in an irrevocable manner.

An excessive degree of regulatory constraints for internal models could potentially render the model validation impossible (e.g. Downturn-LGD). Therefore, in order to design the models in a way that can be validated and operationalised, conservative elements (e.g. multipliers) should be used as model inputs as late as possible. Whilst, on principle we do not want to rule out supervisory backstops in general, in order to guarantee the model validity and adjustments that are as precise as possible, we should still like to point out that supervisory backstops may only be based on a sufficient historic database.

6. Reconsidering the linkage between internal and regulatory models

Every risk measure which is given a prominent position by the supervisor due to the fact that it is predicated on the measurement outputs as the basis for calculating capital requirements (e.g. in the case of VaR) incurs supervisory risks. These risks are even greater, the less this risk measure is integrated into the internal risk management. Whilst not limited to, this especially applies to all standardised approaches

as well as to the Leverage Ratio. Hence, we are convinced that supervisory rules are most efficient if they are in line with business management interests i.e. if, ideally, there is congruence between internal models and regulatory models and if they are based on the same set of management measures or, moreover, model parameters.

In our view the use test has lost in importance and takes on a lower priority since Basel 2.5. In our view this is wrong and it should be reinvigorated again. This is the only way for ensuring the quality of the internal models. After all, this model quality is motivated by banks’ own vested interest in ensuring that the internal models capture specific risks as precisely as possible. Conversely, a complete departure from the use test would sooner or later translate into abandonment of model-based capital requirements. We find this inacceptable.

If conservative add-ons are regarded necessary for the "transition” from internal models to regulatory models, these should be applied outside of the model’s computation core. They should not, for instance, interfere with the model’s correlation structure which is based on self-estimates. This is a *conditio sine qua non* for model results’ internal usability (c.f. above).

We would like to point out that – provided it is feasible in the individual case - congruence between regulatory and internal, business management models would promote harmonisation and reduce complexity in the area of business management. More often than not, Pillar I models are best in those cases where they can be simultaneously used for steering purposes under Pillar II and for business management purposes as well. Indent 66 sets out that regulatory and internal models essentially have conceptual foundations and data sources in common. Based on the foregoing, we can only endorse this statement whilst also pointing out that, in order to ensure risk models that cater to bank-specific idiosyncrasies as well as modelling that is fit for business management purposes, certain differences will explicitly have to be tolerated. This can exceed the individual aspects set out in the current Consultation Paper.

7. Limiting national discretion and improving supervisory consistency

As has already been pointed out in the general comments, in order to restore confidence in internal models, a concerted action is required by banks and supervisors alike. Part of the loss in confidence results from the variability of the model results. As SIG-TB and SIG-BB write themselves, this variability however results to a large extent from the different national approval processes for internal models as well as for the withdrawal of a model license], different partial use possibilities, different model prohibitions for certain portfolios as well as different rules concerning supervisory add-ons (e.g. PD-add-ons or PD-floors). Handling these differences is a task incumbent upon supervisors. At this juncture, in our view, there is still considerable room for improvement.

In this respect, activities should range from an international standardisation of the approval process to concerted action in the field of calculating capital requirements. A consistent, more unified approach is of course also preferable with a view to level playing field aspects.

Regaining trust is also a task for supervisors due to the fact that the public, journalists or also analysts assume that supervisors just rubber-stamp applications for internal models. This is by no means borne out by the reality on the ground. In our experience, quite on the contrary, there are rather strict reviews of the model calculation core, the model infrastructure and the way the model is integrated into internal processes. Hence, it is also incumbent upon supervisors to vigorously debunk such erroneous beliefs in order to prevent any allegation of arbitrary decisions and in order to promote an international harmonisation and transparency between supervisory approval processes. At this juncture, the improvements in supervisory consistency and the guarantee of implementing standards that can be better compared go hand in hand. Also, an improved communication on the reforms in model approaches that have been initialised would contribute to this goal.

It is being pointed out quite correctly that there is room for a better localisation of international standards by allowing national discretion thus taking account of the different structures within the financial systems. For many banks of the respective banking community, this discretion under the national jurisdiction is an important tool which has stood the test of time in dealing with small and medium-sized banks. For this reason, we strongly oppose a restriction of the national room for discretion without a corresponding compensation in the standardised approaches.

8. Improving the accessibility of Basel Committee documents

The Discussion Paper points out that the Basel Committee has initiated a process which seeks to consolidate the existing frameworks into one single document. This is supposed to improve the availability and access to the currently applicable Basel framework conditions. We hold the view that this initiative is extremely helpful and strongly welcome this initiative. At the same time we welcome the improved communication on the initialised reforms for the model approach and furthermore invite the BCBS to ensure coherence of the architecturre regarding the regulatory content and migration options.

9. Adressing factors driving complexity in a more fundamental manner

This section discusses a stronger role for the Leverage Ratio also in combination with the standardised approaches. We understand the considerations at this juncture which are more of a fundamental nature to the effect that an exclusive focus on a (simplified) Leverage Ratio or the Leverage Ratio together with the standardised approach should be contemplated as a regulatory basis and to abrogate model based capital requirements. Naturally, this would be a clear simplification of the regulation. However, it will by no means simplify the ongoing supervisory practice. On the major downsides of the Leverage Ratio please see our comments above. However, also the standardised approaches in conjunction with the Leverage

Ratio are still insufficient as a basis for regulatory capital requirements. These should always be complemented by model based capital requirements:

An initial contemplation of a regulation which is exclusively based on a Leverage Ratio would only be worth considering if it can be assumed that banks are incapable of measuring operative risks in the banking business. However, as a matter of principle, the risk assessment is part of each bank’s core competency. This core competency cannot be replaced by the supervisor.

The proponents of using only a Leverage Ratio as the basis for capital requirements frequently refer to the alleged “illusion that risks can be measured". They claim that this was a situation of "uncertainty” and not of “risk”. Complete ignorance in the decision theory is characterised by the fact that neither all possible outcome manifestations are known nor that it is possible to assign probabilities to the results or, moreover, estimate a probability density function. In this case, it would e.g. be impossible to calculate a VaR which is defined as a quantile of the loss distribution of portfolio losses. This is only possible under "risk”. However, the concepts "uncertainty“ and "risk" are theoretically abstract borderline cases which differ from the extremely heterogeneous situations that can be observed in practice and which are usually somewhere between two extremes. The answer to the question whether it is more appropriate to assume a risk situation or an uncertainty situation especially depends on the availability of data necessary for the model estimate (such as historical data concerning markets or default data).

It would also be appropriate to calculate a VaR of the portfolio losses if, above and beyond this, (for instance in the VaR market risk models) the risk factors of the financial instruments are taken into account and if the possible value changes of a trading portfolio can be readily established (quality of the stochastic model). In the by far largest number of trading portfolios, this may be taken for granted. For banks, the review and assessment of the models is an ongoing work in progress. Banking supervisors equally focus on *de facto* existing model risks (e.g. erroneous estimates). However, such model risks do not render the model use – bearing in mind the model boundaries - obsolete. Whilst modelling simplifications will always be necessary, additionally also the quantitative and qualitative model validation is decisive. In this respect, the supervisor has issued rigid requirements which are also being implemented.

Proponents of the „uncertainty approach" propose a so-called heuristic as a "rule of thumb“ and as a risk metric at least for the supervisor. One heuristic proposed for ensuring the solvency of a bank is the Leverage Ratio. The question however is not satisfactorily answered whether the Leverage Ratio is at all an appropriate heuristic for the purposes of ensuring solvency. Empirical studies into the question to which extent the Leverage Ratio is a ratio that possesses statistically univariate discriminatory powers for the purposes of distinguishing between banks which survive and those which become insolvent do not yield an unambiguous answer. Frequently, no discriminatory power can be proven (cf. above).

Furthermore, the Leverage Ratio is accompanied by a very long – and already widely discussed – list of serious disadvantages. It is particularly worth noting seriously mispremised disincentives and arbitrage opportunities: There are strong incentives for increasing the business models’ degree of risk. Due to the

absence of a risk-weighted treatment of the assets, an AAA investment ties up the same amount of capital as a B investment. From our point of view, it does not appear like a successful strategy to have the supervisory focus on the Leverage Ratio only. What is more, due to banks' risk measuring capacity this is not necessary, either.

However, also a combination of the Leverage Ratio and standardised approaches is insufficient. They always have to be complemented by model based capital requirements:

For a standardised approach, the principle] "one size fits not all banks" applies: Due to the fact that it is not geared towards the portfolio structure of a bank, certain risks cannot be measured at all or only in an imprecise manner (such as certain basis risks). At the same time, this means that a standardised approach will typically only be able to cope with rather simple portfolios. As a result, risks are either overestimated or underestimated. More often than not, there is a failure to adequately capture diversification and hedging effects.

Also, when internal models are not being applied, supervisors refrain from an integration of banks' risk management capacities. On principle, risk assessment is part and parcel of every bank's core competency. This core competence cannot be replaced by the supervisor, either. In addition to this, standardised approaches are simple models. However, supervisors are by no means better “model builders” than banks themselves. Standardised approaches feature considerable deficits as regards risk measurement. On their own, they are not sufficient for the establishment of appropriate capital requirements. In the light of the existing shortcomings of the standardised approaches they are also unfit for purpose as a floor for the model based capital requirements (c.f. above).

If standardised approaches were assigned a greater importance, one of the most pressing problems in need of resolution is that this, at least presently, increases the reliance on external ratings. This undermines the declared goal of, henceforth, avoiding overreliance on external ratings.

The pre commitment approach which has also re-emerged during the deliberations first entered the international debate in the second half of the 1990s (Kopek/O'Brian; The Pre Commitment Approach: Using Incentives to set market risk capital requirements, 1997); it could not assert itself as an approach for calculating the capital requirements in the market risk area. *In lieu* of the pre commitment approach, Basle 1.5 saw the introduction of the VaR based capital requirement. To our knowledge, the authors subsequently withdrew their proposal again due to the fact that its practical implementation seemed hardly possible.

Conclusion

From our point of view, instead of modifying the fundamental policy decisions adopted on the basis of Basel III on a merely theoretical basis in an abstract manner and in the absence of any sufficient

empirical foundation. It would be more conducive towards legal certainty and a reliable planning environment if the ongoing implementation work with regard to the Basel III rules were concluded first. In a second step, its results and experiential values should be gathered.

Especially with regard to the Leverage Ratio, we feel it would be useful to initially analyse the impact of the Leverage Ratio as a corrective factor for the risk based capital adequacy requirements; Based on this, it should then be possible to identify further regulatory need for action. Hence, we see no need for a premature anticipation of the evaluation and potentially the calibration of the Leverage Ratio envisaged for 2017.

The results and experiential values gathered in the context] of the Basel III concept could subsequently serve as a basis for further technical reform plans. Also with a view to a recalibration of the three Pillars of the Basel model, we have strong reservations over any abstract discussion of these proposals if this discussion leads to the introduction of new supervisory requirements. We are of the opinion that such a discussion would be premature and an unconstructive move. With a view to the aforementioned legal certainty and the required reliable planning environment for companies it might even prove counterproductive.

Yours faithfully,
For the German Banking Industry Committee

Dr. Martin Lippert Dr. Johannes Voit