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Die Deutsche Kreditwirtschaft

Response

to the consultation paper "Recognising the cost protection purchased" by the Basel Committee on Banking Supervision

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Response to the consultation paper "Recognising the cost protection purchased" by the Basel Committee on Banking Supervisiondated 21 June 2013

In May 2013, the Basel Committee on Banking Supervision (BCBS) submitted proposals for recognising the cost of credit protection purchased. We are grateful for - and happy to use - the opportunity to respond to the consultation paper. This letter is intended to communicate the position of the German banking industry.

Firstly, we would like to make some general remarks, before discussing the details of the proposals submitted and the questions raised in the consultation paper.

I. General remarks

The purpose of its proposals is to remove "arbitrage opportunities", which, in the opinion of the BCBS, exist in the use of credit risk mitigation tools (guarantees and credit derivatives) within the framework of credit risk mitigation methods and securitisation. The BCBS identifies the danger of arbitrage because the security effect of these tools entails an immediate reduction in risk weights (and thus in the regulatory capital requirements), whilst the cost of such tools only reduces regulatory capital with the passage of time. Accordingly, the secured party should deduct the present value of future premium payments from the regulatory capital.

In our opinion, the BCBS has not provided a sufficient explanation of why it wants to consider credit risk hedging premiums in advance. An effective guarantee or credit derivative replaces the risk of default by the hedged position with the risk of default by the guarantor. This is recognised in the rules of bank regulation by a substitution of risk weights. A position hedged in this way is even more secure than a direct receivable from the guarantor, as both the borrower of the secured receivable and the guarantor would have to default (double default) for the institution accepting the guarantee to suffer a default. Under the proposed rules, more regulatory capital would have to underlie the hedged position than would have to underlie a direct receivable from the guarantee provider. This is economically unjustifiable.

The effectiveness of the transfer of risk is independent of the amount of premiums paid for credit risk hedging. Should a position be hedged by another bank, the banking system as a whole provides at least as much regulatory capital as if the position were not hedged.

Furthermore, in our opinion, the proposed rules represent a systemic inconsistency in respect of regulatory capital requirement. Under the current system, regulatory capital need not underlie future periodically recurrent items of expenditure (e.g. payments of interest on deposits or other liabilities of the bank). There is no financial justification for this principle no longer applying to the case of guarantee premiums. In addition, the increase in regulatory capital from future periodic earnings (particularly interest) is not recognised under the current system. In particular, banks acting as guarantors cannot reduce the capital requirement resulting from the provision of the hedge by offsetting its present value against the premiums to which they are entitled from the hedging at a later point in time.

Last but not least, we would like to point out that the new proposals significantly increase the complexity of bank regulatory rules and would thus entail considerable outlay for implementation at financial institutions. This is regarded very critically, particularly against the background of the multitude of projected rules currently under discussion or being implemented.

In our opinion, the above-mentioned systemic inconsistency would not be corrected even if the institutions could offset the spread income from the hedged positions.

It is also absolutely necessary for transactions of which the cost of credit protection has already reduced regulatory capital to be exempt from application of these proposed rules. Otherwise, the result would be double recognition of costs, which would be inappropriate in our view. For this reason, it should be stated that recognition of the costs in the current year is also sufficient for exemption from application.

We also consider it necessary to harmonise the proposals for the recognition of cost protection with those for the regulations on securitisation. The proposals for revision of the regulations on securitisation suggest a considerable increase in the capital requirements for securitisation exposure. If the proposals made here were implemented, a greater extent of securitisation would probably be covered by their scope. In order to avoid an additional increase in capital requirements, particularly for securitisation exposure, the interaction of the proposals should be examined and adapted if necessary.

II. Particular remarks

Notwithstanding our general remarks, we wish to consider the questions raised in the consultation paper, below.

Q1: *In addition to the 150% risk-weight threshold, should additional exemptions for certain types of transactions be considered? In particular, the Committee welcomes feedback on (1) exposures guaranteed by governmental entities (including sovereigns and public sector entities) and (2) trade finance transactions with guarantees.*

Setting a materiality threshold

The BCBS proposes a restriction of the scope of application in the form of a risk-weight materiality threshold of 150% (without credit risk mitigation) for determining credit protection costs. However, the consultation paper provides no information on how this limit was determined. We would welcome corresponding information from the BCBS.

In any case, a distinction should be made between securitisation and other exposure when setting the materiality threshold. A risk weight of 150% may be high for exposures using the standard approach, but it is comparatively low for securitisation. This is particularly the case if the risk weights from the BCBS consultation paper of December 2012 ("Revisions to the Basel Securitisation Framework") are used as a basis. Under these rules, risk weights in excess of 150% would have to be applied to some securitisation exposure already rated AAA (RRBA, thin, maturity: 5 y). In this connection, we would like to point out that the transfer of mezzanine tranches for originators in the EU represents the most important opportunity for substantiating a significant transfer of risk in the case of securitisation. The proposals in the consultation paper would make such a transfer considerably more difficult. Notwithstanding our fundamental rejection of the Basel proposals, we therefore favour the application of the rules to first-loss securitisation positions only.

Moreover, in cases in which subordination only resulted from provision of the hedging instrument, the average risk weight of the receivable in the underlying portfolio should be crucial, not the risk weight of the tranche.

The BCBS proposals also anticipate the opportunity for national regulatory authorities to demand recognition of credit protection costs below the materiality threshold too. In our opinion, a fixed materiality threshold against the background of the objectives set should suffice. An individual extension of the scope of application and the associated uncertainty would entail higher bureaucratic outlay and distortions of competition. In future, new transactions or deals would first have to be agreed with the regulator, entailing longer lead times for new transactions. Such additional outlay should be avoided if possible.

Exemption for normal lending business and existing hedged positions

Normal lending business should be exempt from the requirements at all costs. Otherwise the additional regulatory requirements would entail the banks having to pass on the costs associated with regulation to the borrowing economy, so the borrowing conditions for business would worsen.

As well as a statement that normal lending should not be covered by the rule, existing hedged positions should be expressly exempt as well. They were assumed in the belief that the current rules would continue to apply. A subsequent change could entail transactions subsequently becoming uneconomic.

Exemption for security providers with a risk weight of 0%

Credit risk hedging provided by governmental entities should be exempt whatever the circumstances. State guarantees were provided for high-risk lending portfolios to stabilise the financial markets, particularly during the financial crisis. If the associated costs for the bank now have to be recognised in advance, there could be a serious backlash against the stability of individual banks, which could also bring pressure on the banking system as a whole. We therefore suggest exempting all hedging originating from addresses which have received a risk weight of 0% in the standard approach. In this connection, we would again refer to our general remarks that recognition of the cost of credit risk hedging in the current year should be sufficient to gain exemption from the scope of application.

Exemption for trade finance

In terms of amounts, guaranteed trade finance is relatively low in relation to other transactions, and is usually short-term. Such transactions should therefore not be the target or substance of concerns of the BCBS. During a weak economic cycle and at a time of uncertain economic growth, an additional capital requirement and the associated increase in the costs of guaranteed trade finance would have a negative effect on the real economy. Guaranteed trade finance should also be exempt from the scope of application for this reason.

Exemption for market-rated CDS

Hedging instruments rated at fair value (e.g. CDS) implicitly recognise the costs of credit default protection in the market rating. The market value of the hedging instrument therefore reflects the costs which the protection buyer would incur. Although a market value of 0 is generally assumed when a CDS is purchased, it consists of two components: the future cost and the future benefit. Appropriate recognition is given to the components in CET1 by the market rating. For this reason, we suggest exempting market-rated CDS from the scope of application of the consultation paper too.

Q2: *The Committee welcomes feedback on all aspects of the proposed changes to the rules text and the supplementary technical guidance.*

Clarification of the scope of application

In our opinion, it is not clear from the consultation paper whether the BCBS proposals only affect the investment book or the trading book as well, due to the relationship with credit risk mitigation methods and the examples presented. We are currently assuming rules for the investment book. For the purposes of clarification, it should be explicitly stated that trading book positions, which are the subject of capital requirements for market risks (including securitisation positions in the trading book), are not covered by the consultation paper.

Avoiding national discretion

The BCBS proposal anticipates numerous discretions for national regulators (e.g. the amount of the discount rate, the choice of calculation method and the scope of application). Such options would produce national differences in regulation with further opportunities for arbitrage, which is precisely what should be avoided, in our opinion. We reject such national discretion for the regulators, for the sake of a level playing field. On the contrary, a binding approach should be prepared within the scope of consultation, in conjunction with representatives of the industry, which would then be applied uniformly in every jurisdiction.

Recognition of spread income

The BCBS submits three methods of recognising spread income:

1. Present value of costs less Present value of the spread income

2. Present value of costs less spread income

3. Disregarding spread income

Notwithstanding our general remarks, we consider it imperative that spread income be recognised. Recognizing crediting spread income is to be the rule and no restrictive conditions should be applied to it. We therefore reject disregarding spread income (alternative 3).

In the case of the second alternative, the differences between spread income and the costs of the position in each period are restricted to 0. We have reservations about this approach. In particular, the grant of discounts may result in a negative excess spread when the transaction is issued, which is then absorbed in subsequent periods. This proposed alternative would lead to an unnecessary additional capital requirement. In our opinion, the temporal dependency of payments already receives adequate recognition by the use of discount factors. Additional floor formation in every period appears too conservative to us.

We consider example no. 7, in which the entire portfolio defaults after conclusion of the security agreement and thus no spread income is generated, to be utterly unrealistic. In our opinion, this could only result if non-performing loans had been securitised. In such a case, the present value would be applied, without recognition of the spread income.

Moreover, we demand that it be clearly stated that, in a case in which the bank bears the first loss, the costs of credit protection need only be credited to the extent to which their present value exceeds the first loss (deducted from regulatory capital or risk-weighted at 1250%).

Risk-free versus risk discounting factor

In answering the question of whether the present value should be calculated risk-free or using a risk rate, the risk weight of the position to be hedged should above all be regarded as crucial. Of course, the greater the risk of the position to be hedged, the higher the premiums. It is therefore inappropriate to discount the present value of the premium payments for high-risk position with a risk-free factor. The rules proposed by the BCBS would, in our opinion, produce an impenetrable web of exceptions and reverse exceptions which would render any future regulatory consideration of hedging impossible.

Determining significant transfer of risk

Under current legislation, securitisation exposure credited with a risk weight of 1250% need not be considered when determining significant transfer of risk. We assume that nothing will change in this respect.