

Impact of the Prohibition of or Constraints on the Use of Internal Model Approaches on Non-Financial Companies Should Be Evaluated Carefully

Concerns on potential discrimination of
highly solvent companies

Deutsches Aktieninstitut welcomes the opportunity to respond to the consultative document “Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches” issued by the Basel Committee on Banking Supervision (BCBS) in March 2016.

This position paper briefly summarizes the comments of German non-financial companies on the consultation paper. Our view is based on discussions in the corporate finance/corporate treasury working group of Deutsches Aktieninstitut which is the central forum of opinion building for the treasury departments of the largest German non-financial companies, many of them with assets exceeding EUR 50bn.

Non-financial companies have generally supported the strengthening of capital requirements as well as the introduction of additional measures against possible bank failures in the aftermath of the crisis. From our point of view a strict regulation of banks is pivotal to an effective credit intermediation and a reliable provision of financial market services to the economy. We are also aware that the new regulation is not costless for banks and, consequently, the companies of the real economy. Non-financial companies have in general accepted these effects as the “price” for increased systemic stability.

Constraints may discriminate against highly solvent large corporates

However, it is our understanding that the new BCBS proposals will not only further increase capital requirements but generally aim at prohibiting or, at least, limiting the use of internal models (IRB) for the calculation of risk-weighted assets, in particular for exposures to large non-financial companies (chapter 2.2 in conjunction with chapter 4.2 and 4.3.) and for so-called CVA risks (chapter 2.4).

Though the members of our working committee as users of financial services are not in the position to comment on technical details of banks’ internal models our preliminary analysis lets us come to the conclusion that the consultation paper may have some unintended consequences.

More concretely, we are concerned that the BCBS proposal will discriminate specifically against highly-solvent non-financial companies without objective reason. This may be particularly true for investment grade companies which proved reliable debtors and counterparties as well as anchors for the stability of markets even during the financial crisis. In the same way, financing conditions, i.e. prices as well as volume available, for this group of customers may worsen because we expect that the risk weights in the standardized approach will normally be much higher than in sophisticated internal models. The same may happen with undrawn credit lines. These credit lines are particularly important for the large non-financial companies because they serve as a backup for any unforeseen sudden financial needs and usually remain undrawn. However, even if undrawn they are important

for external rating purposes and, thus, capital market funding as an alternative source of finance.

Besides this, we have not yet captured the rationale for prohibiting or limiting the use of internal models regarding exposures to large corporates for systematic reasons. Basically, this appears to be a move back in the design of banking regulation. The argument that in a low-default environment parameter estimation is more difficult and therefore the standardized approach based on market data estimates and external ratings is preferable is not very convincing – at least without data to support this view. According to our experience, we would rather expect that banks' internal data collected over a long period of time (credit history with customers) is more reliable than linking important parameters to external ratings. Overall we therefore question the implicit assumption that large non-financial companies are different from others so that their default risks are difficult to model. At least and as far as we are informed IRB models which are also supervised by the authorities have significantly more rating grades that allow a more gradual increase in the risk weights according to the risk situation of the company.

In addition, forcing banks to use the standardized approach or limited internal models may not be necessarily superior from a systemic point of view as it may increase the dependency on external ratings. It could also be argued that some degree of variation of internal models and, thus, of the judgement of risk and the capital buffers resulting from it prevents homogeneity in banks' vulnerability, e.g. to external shocks.

Non-financial companies open for dialogue

Against the background of our preliminary analysis, we would appreciate if the Basel Committee evaluated and disclosed in detail the consequences of the proposal for non-financial companies before any final decision is taken. We would also be most willing to enter into a dialogue in order to provide additional feedback from the non-financial companies indirectly affected by the proposal.

Please do not hesitate to contact us if you have further questions. We remain at your disposal should you be interested in the dialogue with German non-financial companies.

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