

Comments

on Revisions to the Standardised Approach for credit risk

Date

11 March 2016

Page

1 of 5

The Federation of German Industries (BDI)¹ welcomes the opportunity to comment on the second consultation document of the Basel Committee on Banking Supervision on revising the Standardised Approach for credit risk, published on 10 December 2015. BDI has always been supportive of a financial market regulation that aims to make banks and the financial sector more resilient to absorb shocks and at the same time secure their financing role for the real economy.

1. General remarks

The consultative document contains important improvements compared to the first draft. BDI appreciates that the Basel Committee refrains from its original plan replacing external ratings by risk drivers that were not appropriate for the determination of risk weights of SMEs.

We welcome that our concerns brought forward in our former comments to the first draft with regard to the risk weights for SMEs have been taken into account. In particular, we appreciate that the Basel Committee now intends to incorporate medium sized enterprises in the retail exposure class that is in line with the current European Capital Requirements Regulation. We also endorse that the Basel Committee now envisages a preferential risk weight for corporate SMEs. Finally, we appreciate that the Basel Committee has given up to assigning a risk weight of 300 % in case of unavailability of a current financial statement to provide revenue and leverage data to the lending bank.

Against this background, the revised proposals are steps in the right direction. Nevertheless, the envisaged changes in the Standardised Approach for credit risk will create additional capital requirements for credit institutions. They do not seem appropriate and will eventually result in higher costs for the enterprises of the real economy. Our comment addresses the following points:

**Federation of German
Industries (BDI)**
Member Association of
BUSINESSEUROPE

Phone Contacts

T: +493020281422

F: +493020282422

Internet

www.bdi.eu

E-Mail

r.kudiss@bdi.eu

¹ Federation of German Industries (BDI) is the umbrella organisation of German Industry and industry-related service providers. It represents 40 industrial sector federations and has 15 regional offices in the German Laender. BDI speaks for more than 100.000 private enterprises – 98 % small and medium sized – employing around 8 million people.

- The re-calibration of credit conversion factors (CCFs) for off-balance sheet exposures would end-up in a significant increase of financing costs for SMEs. In our view, it is not commensurate to credit risk that there is no distinction between those credit facilities that can be cancelled at any time by the credit institution and those credit facilities that are irrevocable and that have a maturity of one year or more. In order to avoid additional commitment fees for credit facilities it should be abstained from higher risk weights.
- Considerably higher risk weights for equity holdings and subordinated debt would counteract the efforts to re-balance the capital structure of firms causing unintended damage to the economy.
- The significant increase of the risk weights for real estate exposures would worsen conditions for residential and commercial property financing, thereby entail unnecessary burden for the real estate sector and the real economy as a whole.

2. Specific remarks

Risk weights for SME's exposures

We welcome the reduction of the risk weight for corporate SME exposures. Moreover, we appreciate that the current draft version incorporates medium sized enterprises that qualify for the 75 % preferential risk for retail exposures. Consequently, potential adverse effects resulting from disproportionate capital requirements for SMEs exposures that do not benefit from the preferential risk-weight treatment are eliminated. We strongly welcome this.

Non-SME-Corporate exposures may continue to be risk-weighted by reference to the external credit rating of the corporate. However, an internal review of the external rating shall take place that is not fully new. Banks shall use these internal reviews in the context of the internal rating process for the purpose of determining the risk weights and thus for capital requirements. In practice, institutions using the internal-ratings-based (IRB) approach might be required to map the internal rating to the external rating and to use the worse of the two ratings for the purpose of capital adequacy. For some corporate exposures, this implies higher capital requirements, though more moderate compared with the proposals set out in the first consultation paper. However, the revision of the regulatory framework does not only affect banks, which operate under that Standardised Approach, but also those that rely on internal models.

A proper risk assessment might require external ratings complemented by other factors. An exclusively ratings-based analysis might not always reflect the latest state of affairs, especially in times of volatile markets. Therefore, a review of the external rating seems comprehensible. However, the requirement to conduct an own due diligence should be in line with what can be expected in the normal credit business. In any case, additional burden for banks and enterprises should be avoided.

Credit Conversion Factors for off-balance sheet exposures

To overcome the supposed weaknesses with regard to off-balance sheet exposures, the Committee envisages a re-calibration of the current credit conversion factors. The calibration of CCFs for unconditionally cancellable commitments are still too high. As capital requirements for banks are an important determinant of lending rates and credit facilities granted to clients, the re-calibration of CCFs for off-balance sheet exposures would end-up in a significant push of financing costs for corporate SMEs.

Particularly affected by this are commitments that are unconditionally cancellable and commitments with maturities up to 1 year. Currently, a credit conversion factor of 0 % respectively 20 % is applied on them. The Committee proposes to apply a CCF between 50 % and 75 % for commitments that are unconditionally cancellable regardless of their maturity. We consider these values as much too high.

Unfortunately, relief is only provided for retail commitments that a bank may cancel unconditionally and at any time without prior notice. For this purpose, a conversion factor in the range of 10 % and 20 % is envisaged which could be appropriate. However, we consider an extension of these favorable CCF ratios to all SME exposures, including SME borrowers that do not meet the criteria for retail exposures, as necessary. A substantial and unjustified increase of the CCF would create a disincentive for banks to provide credit lines and hence reduce the flexibility needed by many companies, with considerable adverse consequences for company financial planning.

Subordinated debt, equity and other capital instruments

The 2014 consultative document proposed to enhance the risk sensitivity of the framework by introducing specific treatments for subordinated debt, equity and other capital instruments issued by banks and corporates. We appreciate that the Committee recognised that the risk weights included in the 2014 consultative document might be too conservative causing unintended damage to the economy. In its current draft, the Committee suggests to apply a 250 % risk weight for equity holdings that are not deducted. For subordinated debt and capital instruments other than equities below the threshold deductions, the Committee proposes a 150 % risk weight. We regard the re-calibrated risk weights as more in line with the specific risk profile of bank's equity and subordinated debt exposures.

Despite the improvements suggested, the proposed risk weights continue to have an adverse impact on the regulatory capital requirements for existing investments. We are concerned that own fund financing of enterprises by banks could become more difficult to obtain and existing holdings could likely be sold by banks. Especially in Europe, banks hold significant holdings of companies. This has a great significance for the overall economy. The economic rationale for such holdings would become obsolete if capital requirements for this asset class increase. Moreover, a growing number of companies independent of size recognise how important it is to

optimise their capital structures in favour of equity because this allows them to have easier access to bank financing and the capital market.

Higher risk weights could lead to substantial disinvestment flows that are contradictory to efforts to increase growth and investment in the EU and create a comprehensive Capital Markets Union. Applying a 250 % risk weight for equity is disproportionate and excessively conservative, compared to a currently appropriate risk weight of 100 % for corporate exposures and subordinated debt. To mitigate the serious interventions for banks that apply the Standardised Approach, it is essential that the risk weights for existing equity, subordinated debt and other capital instruments remain at their current level under the CRR.

Claims secured by residential and commercial real estate

The risk weights for residential and commercial real estate of 35 % and 50 % respectively will be significantly increased, and even doubled in some cases. So far, no distinction is made whether the property is owner-occupied or rented. This will be modified with the current proposals. We consider it inappropriate to apply risk weights of up to 75 % for owner-occupied housing. This represents a high burden for the real estate industry compared to the currently much lower risk weights. Similar criticism applies to the proposal for loans secured by commercial real estate. Under this scheme, a doubling of the risk weighting for rented commercial properties has been proposed.

The ongoing stability of the German real estate market gives no indications that justify a higher risk weighting of rented versus owner-occupied commercial properties. The so-called “hard test” that the German Federal Financial Supervisory Authority (BaFin) performs to fulfill Article 125 paragraph 3 and 4 and Article 199 paragraph 3 of CRR (EU Regulation No. 575/2013), reveals that loss rates stemming from lending collateralised by residential property are substantially lower than the maximum allowed rates. The loss rate in 2014 of 0.05 for residential real estate loans was exact the same for commercial real estate loans.

We regard the proposed substantial increases in risk weights of real estate exposures as highly problematic, as the new scheme will lead to profound changes for lending to the property sector. The German real estate industry represents a crucial factor in the German economy. Rented commercial properties are of great economic importance. The German real estate sector provides facilities for manufacturing, sales, warehouses and offices for about 30 % of all companies.

If the financing conditions of the real estate economy deteriorated, the supply of real estate to the real economy as a whole would also deteriorate. In addition, the proposed changes are a negative signal for the supply of housing. The specifications make the construction of rental flats more expensive. This would significantly impair the efforts of the real estate sector and the German government to provide affordable housing. A further

reason why the proposal is not appropriate is that the value of the loan-to-value (LTV) ratio does not take account of the national differences in the valuation of the property.

3. Concluding remarks

To strike the right balance between the regulatory treatment of corporates' exposures and the economic need to promote growth and employment by a smooth financing of companies, further adjustments to the consultative document are necessary:

- A too conservative calibration of the risk weights for SMEs' exposures must be avoided, as these companies are very often financed by financial institutes applying the Standardised Approach for credit risk. Also against this background, the revised CCFs continue to be too high. This especially applies to commitments that are unconditionally cancellable at any time.
- There is no justification for a significant increase of risk weights for equity and equity-related capital injections of banks. Too high risk weights would clearly counter the obvious need to restructure firms' balance sheets to ensure a sustainable access to finance. The respective risk weights should remain unchanged.
- Too high risk weights for claims secured by real estate are counterproductive with a view to the significant value contribution of the real estate sector for the real economy. In particular, they run counter to the EU's efforts to improve the financing conditions of companies. Moreover, they ignore the realities of the real estate market in Germany and in other EU countries.