

Comments on Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches

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Federation of German Industries (BDI)¹ welcomes the opportunity to comment on the consultation document “Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches” issued by the Basel Committee in March 2016. BDI has always supported the financial market regulation that aims to make banks and the financial sector more resilient to shocks and at the same time secure their financing role for the real economy. However, we are concerned that the proposed measures could have unintended negative consequences for non-financial companies.

1. General remarks

The Basel Committee aims reducing variation in RWAs by increasing constraints on the use of internal model approaches by a number of complementary measures, in particular by removing or restricting the option to use the IRB approaches for certain exposures.

According to the Committee, these changes will not lead to a “significant capital increase”. Although, this might be true on a global scale, we are concerned that the proposals will induce a significant increase in RWAs and higher capital requirements for European banks, thus making access to finance for non-financial companies more costly.

Even the revision of the standard approach leads to significantly increased capital requirements. The BDI has repeatedly expressed its concerns about the proposed regulatory tightening. Combined with upcoming regulation such as NSFR and the leverage ratio, the reform proposals for the IRB approach could exacerbate this tendency and lead to considerably higher financing costs for the companies of the real sector and thus hinder growth and job creation.

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.

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2. Specific remarks

According to European authorities' first estimates, for European banks, on average, the proposed Basel regulations would lead to an increase in RWAs by approximately one quarter, thus causing severe competitive distortions to US competitors that do not allow external ratings for regulatory purposes. The higher capital charges are transmitted to the real economy. Considering the financing structure of the European economy, we assume that the negative impact on European companies would be significantly higher.

The overall effect of higher capital requirements place a considerable burden on banks that increasingly challenges proved and tested business models that are of particular significance for the real economy.

Especially larger non-financial companies that currently benefit from advanced internal rating models are suffering from the new regulatory framework. For this class of bank customers, financing conditions in terms of prices and volumes available may worsen. There are no convincing arguments for a discrimination of large companies.

Forcing banks to use the new standardized approach or limited internal models is no proper alternative. There are indications that the risk weights are significantly higher in the standard approach for large enterprises than in internal models. Consequently, credits, credit lines and hedging transactions of companies will become more expensive.

Overall, we consider the proposals of the Basel Committee as a step back in the effort to secure financial stability. For banks, it could be likely to be less attractive to invest in sophisticated internal risk assessment models. Banks' internal data that have been collected for a long period of time are reliable and better suited to manage risk as publicly accessible market data.

The envisaged regulatory changes will also hamper the success of the EU Capital Market Union. Higher capital requirements withdraw liquidity from the market. Under the proposed calibration, providing derivative or market making services for non-financial companies would become prohibitive, which is detrimental to the financing needs of companies.

Besides this, the proposals of the Basel Committee undermine the plans of the European Commission to reduce the over-reliance on credit ratings by rating agencies, and instead strengthen the professional risk assessment of banks.

3. Concluding remarks

We expect negative macroeconomic consequences of the regulatory changes. 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:

- Overall, the risk weights need to be re-calibrated to better reflect the actual risk and to ensure a level playing field with the US.
- The scope of the use of internal models for the calculation of RWAs should not be limited. At least, the thresholds for the IRB approach should be increased considerably.
- In any event, the Basel Committee should evaluate in detail the consequences of the proposal for non-financial companies before a final decision is made.