

Comments

on the Basel Committee on Banking Supervision's
second consultative document on revisions to the
standardised approach for credit risk

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

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Dear Madam, dear Sir,

On 10 December 2015, the Basel Committee on Banking Supervision issued its second consultative document on revisions to the standardised approach (SA) to credit risk. We appreciate the opportunity to respond to this document.

1. General remarks

The credit risk SA was introduced under Basel II to particularly enable small and medium-sized banks to fulfil regulatory capital requirements for credit risk with a reasonable amount of time and effort. There is a need, against this background, to keep the additional burden imposed on these banks to a minimum. We believe the Basel Committee should, in addition, confine its revisions to areas where shortcomings have been identified in the existing regime.

Given the anticipated additional function of the SA as a floor for capital requirements calculated under the internal ratings-based (IRB) approach, the SA also needs to be as risk-sensitive as possible without further increasing its complexity. The suitability of a standardised approach as a floor for ratings-based capital requirements is closely linked to the risk sensitivity of the SA compared to the ratings-based approach. Risk sensitivity is also extremely important given the idea under discussion of no longer permitting the application of the IRB approach to certain exposure classes. That would substantially increase the RWAs of banks using the IRB approach and this point already needs to be taken into account at this stage. As the Basel Committee has itself pointed out, the changes planned for 2016 are not intended to significantly increase capital requirements overall.

In general, we consider a floor of 100% unacceptable since it would eliminate the capital relief-based incentive to continue using the IRB approach. Any floor needs to be set considerably lower than at 100%. This demonstrates the urgent need for greater coordination between parallel projects undertaken by the Basel Committee. Another major problem for banks using the IRB approach is that far fewer types of collateral are eligible for recognition under the SA. The Basel Committee should consider extending the list of eligible collateral for the SA according the IRB approach.

The full implications of this consultative document for banks using the IRB approach can only be assessed once the interaction between the requirements of the new SA and the floor for IRB banks based on this approach is considered.

We welcome the Committee's decision to reintroduce the use of external ratings and to drop the proposal in its first consultative document for a complete removal of their use. The withdrawal of the 300% risk weight in the exposure classes for banks and corporates is also a step in the right direction. By abandoning the plan to dispense with external ratings altogether, the Committee has taken the banking industry's concerns on board and will ensure a risk-sensitive approach at least where external ratings are available.

The proposals in the second consultative document continue to envisage a high degree of complexity in some exposure classes and for unrated banks. This will make implementation very costly and time-consuming, and will also result in high running costs, such as those necessary for keeping data up to

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date. With this in mind, we suggest keeping the due diligence requirements to a minimum. It should be borne in mind that some countries already require banks not to rely exclusively on external ratings.

We welcome the distinction between "regulatory retail" and "other retail" exposures aimed at increasing risk sensitivity. We nevertheless believe that exposures to SMEs which do not belong in either the corporate or regulatory retail exposure class should be included in the calculation of the granularity threshold. We would also suggest reconsidering the proposed 85% risk weight for these exposures. This is because the ratio of unexpected to expected losses on loans to SMEs is much more favourable than that for loans to large companies. The statistically observable higher default rate by SMEs translates into higher expected, but not necessarily higher unexpected, losses. These higher expected losses are already reflected in the pricing of the loans. It should be borne in mind that capital requirements are intended to cover unexpected, not expected, loss.

We assume that the approach of using only one risk factor as the basis for differentiating capital requirements in certain exposure classes and for loans secured by real estate will reduce – not increase – the comparability of capital requirements and capital adequacy.

It is, in our view, highly important that the use of so-called real estate loan splitting continues to be permitted for loans secured by real estate. Given the positive experience with this practice to date, this would also be justified.

We are deeply concerned about the sometimes huge increases in capital requirements compared to the existing SA. Though we regard the changes made to the initial proposal as a positive sign on the part of the BCBS, we still see serious disadvantages as a result of higher risk weights and additional complexity for banks.

The quantitative impact study (QIS) which will begin in March 2016 based on data as of 31 December 2015 should be used to analyse the implications of the proposals for the industry and adjustments should be made in the light of this analysis. National specificities (in property markets, for instance) and the interests of small and medium-sized banks need to be given greater consideration. We support the objective of not increasing overall capital requirements. We nevertheless have major concerns about some of the assumptions on which the Committee's thinking is based. In particular, the QIS should also be used to investigate the effects of the proposals on other aspects of regulation, such as the leverage ratio or large exposures regime.

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2. Detailed comments

Exposures to banks

Paras 14-15 Due diligence requirements

We support the uniform use of external ratings since this ensures, among other things, that the level of capital charges is comparable worldwide. In Europe, loan decisions are not made exclusively on the basis of external ratings: banks always also carry out their own assessment of the riskiness of the exposure and the creditworthiness of the borrower.

As we see it, however, the due diligence process cannot consist of comparing external ratings with a separate internal credit analysis for every single borrower in the form of mapping, for instance. We believe it should be sufficient to check at a higher level – e.g. certain homogeneous groups of borrowers, certain asset classes or possibly only per agency – that the risk weights assigned on the basis of external ratings are appropriate to the risk profile and characteristics of the borrowers. It should also be possible for a central unit to carry out these checks rather than requiring each individual bank to perform the task itself. Any other interpretation would lead to an enormous amount of additional work and expense which, for smaller banks in particular, would be virtually unmanageable. We would appreciate clarification of this point. For the reasons outlined above, we are opposed to due diligence in the form of analysis at the level of individual borrowers.

We understand the requirement to perform due diligence “on a regular basis (at least annually)” to mean only that the analysis has to be performed at regular intervals, not on an ad-hoc basis. We would ask for clarification of this point, too, in the interests of consistent implementation and handling.

Paras 17-18 External Credit Risk Assessment Approach (ECRA)

A precondition for using external ratings is the acquisition by the bank of a costly licence. Even if the bank has obtained a licence from one agency, the borrower may only be able to be externally rated by a different agency. Even if external ratings exist, banks should not be obliged to use them. It should be possible to use the SCRA as a fall-back option.

According to para 17, subparagraph 1, the external rating must not contain assumptions of government support. It is our understanding that not all rating agencies meet this requirement as things stand. Banks are not able to “filter out” the support component retroactively, however. The Basel Committee should therefore approach the rating agencies and ask them to fulfil this requirement.

According to para 17, subparagraph 2, due diligence analysis must never result in the application of lower risk weights than those determined on the basis of external ratings. We do not consider this requirement appropriate. Banks have to be able to demonstrate the quality of their due diligence analysis (para 15). This analysis may, for example, find that the external ratings assigned by agencies to a certain banking group in a certain country are too low. If this finding does not result in lower risk weights being allowed to be applied, the entire due diligence process loses credibility.

Even if we basically accept that the option – known as Option 1 – of basing risk weights on sovereign ratings is to be dropped, this method at least had the advantage of simplicity in terms of the amount of data needing to be obtained. We would therefore suggest that at least banks with only minor exposures to other banks should be allowed to continue using this option.

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Para 18 requires maturity differentiation to be calculated on the basis of the original maturity. We do not consider this appropriate from a risk perspective. We believe calculations should be based on residual maturities instead. Under Article 120(2) of the CRR, the maturity for short-term exposures to banks of up to three months is to be determined on the basis of the residual maturity. This is the correct approach since both external rating agencies and banks monitor the creditworthiness of banks continuously. Both rating agencies and banks in Europe have to comply with the requirements of the CRA Regulation in the process. In Germany, BaFin's Minimum Requirements for Risk Management (MaRisk) also require banks to monitor creditworthiness on a continuous basis and make intra-year adjustments to credit assessments. Given the availability of up-to-date information, the risk of exposures to two banks with the same rating and risk profile, different original maturities but identical residual maturities, is comparable. With residual maturities of three months and an up-to-date rating, the period in which the risk may be realised is the same. It would make no sense to have to apply different risk weights for a comparable risk because of different residual maturities. Any increase in the risk of a longer loan would already have been taken into account during the life of the loan before the reporting date and would be reflected in adjustments to the external rating and internal risk assessment. In such a case, this would have already translated into a higher risk weight. The use of original maturity as a basis would lead to an inappropriate double counting of risk – once because of the maturity element and once because of the possible deterioration in the creditworthiness assessment.

Paras 19-29 Standardised Credit Risk Approach (SCRA)

The process of assigning the three proposed grades will be much more onerous compared to the status quo due to the amount of data which will need to be collected. A significant increase in risk weights is also likely.

The question arises, especially when using the SCRA as the fall-back option, as how to differentiate between group and individual data for determining the risk weight. According to section 1.1.1(b) of the consultative document, banks should classify unrated exposures to banks as Grade A, B or C on the basis of the extent to which the bank meets minimum regulatory requirements. Information about prudential ratios can be found in banks' pillar 3 reports. The Basel framework only requires parent companies to publish disclosures on a consolidated basis, however. We consequently assume that classifications under the SCRA can be based on data of the parent company, if no data from subsidiaries are disclosed.

It is not clear how risk weights are to be derived if the information needed to assign a grade remains unobtainable despite a bank's proven best efforts. Take, for instance, information about banks in less developed countries. We would not consider it appropriate to automatically assign Grade C to all such exposures. The increased element of uncertainty can be adequately reflected by assigning Grade B.

The Committee should clarify exactly what is to be understood by "published minimum regulatory requirements and buffers." We assume the locally applicable minimum standards for capital and leverage/liquidity ratios are meant (paras 21, 24).

Exposures to securities firms and other financial institutions

It should be clarified that the exposure class "exposure to banks" also covers firms subject to banking regulatory requirements (capital requirements, large exposures regime, liquidity coverage ratio, etc.) on a consolidated basis. This point is especially relevant to specialised institutions with no deposit-taking

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business and to leasing companies which belong to a group supervised on a consolidated basis and subject to capital and other regulatory requirements.

Para 30 mentions "risk drivers" although this concept has been dropped from the second consultative document. The wording needs to be adjusted here.

Exposures to corporates

Paras 32-37 General corporate exposures

Para 37 allows a preferential risk weight of 85% to be applied to unrated exposures to corporate SMEs. We welcome the Basel Committee's recognition of the fact that such exposures carry less risk than do "normal" exposures to corporates. We nevertheless believe the reduction in the risk weight does not yet go far enough compared to the equivalent requirement in the EU, for example. In the interests of consistency and to avoid overstating the risks of SMEs, a 75% risk weight is needed – and would also be appropriate at international level, in our view. Otherwise, we not only see a danger of portraying SMEs' risk of default as far higher than it actually is, but are also critical of the Committee's proposed requirements exceeding those in Europe. These requirements need to be reconsidered and reduced to a realistic level which more accurately reflects the true risk emanating from SMEs.

Paras 38-41 Specialised lending

In the new SA for credit risk income-producing real estate exposures shall not be treated as specialised lending exposures. We appreciate this approach. We would, in principle, welcome if this exemption were incorporated in the upcoming revision of the IRBA. Nevertheless, the appropriate treatment of these exposures in the IRBA remains to be discussed.

Under the second bullet point in para 38, there is a danger that, if an entity is split into an operating and holding company, the exposure to the holding company might have to be classified as "specialised lending". This would not be appropriate.

In Germany, it is quite usual for SMEs to split into an operating and a holding company for tax reasons. The company premises is retained by the holding company and let to the operating company. The holding company receives rent; these payments completely depend on the operating company's creditworthiness. From a risk perspective, the two companies form a single economic unit which, from an economic point of view, does not differ in any way from a "normal" company. It would therefore not be appropriate, in our view, to assign a higher risk weight to the holding company only on the basis of the split. For holding companies which are the result of a split and which receive rent from the operating company, the rules for general corporate exposures should apply.

Under para 41, a distinction has to be made between the pre-operational and operational phases of project finance exposures. We agree with the Committee's assessment that the pre-operational phase carries higher risks. It is important to clarify when the transition from pre-operational to operational occurs. This should not be defined as the point at which the project is "completed and fully operational", but be an earlier point in time. Banks should be able to establish their own internal risk-based criteria for determining when the transition can be assumed to have occurred. This will ensure that the requirement can be applied with a certain amount of flexibility.

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Exposures to subordinated debt, equity and other capital instruments

We welcome the reductions compared to the first consultative document in the risk weights for exposures to subordinated debt, equity and other capital instruments. We nevertheless still consider the proposed risk weight of 250% for equity holdings and 150% for subordinated debt and other capital instruments to be too high. For equity holdings, in particular, we would suggest a risk weight of 200%.

Retail exposures

We are opposed to the mandatory application of the granularity criterion (0.2% of the overall regulatory retail portfolio) for differentiating between "regulatory retail" and "other retail" exposures. For smaller banks with a small retail portfolio, this criterion would translate into an extremely small maximum exposure amount, substantially undermining their competitiveness. If a bank had a retail portfolio of 200 million euros, for instance, its exposure to a single counterparty could not exceed 400,000 euros. A rule of this kind would have an especially adverse effect on lending to SMEs. Loans to SMEs would become significantly more expensive and/or lending volumes would be significantly reduced. We therefore strongly recommend that it should be possible to demonstrate the diversification of a retail portfolio using methods other than the mandatory verification of the granularity criterion. There are, moreover, cases – as the Basel Committee itself points out – where national discretion may be required concerning the granularity criterion and its application to the retail portfolio. This should continue to be the basis for treatment at small banks, in particular.

For almost all exposure classes, the consultative document proposes greater differentiation than under the current standardised approach; this differentiation provides for greater risk sensitivity, and is both simple and objective. The retail portfolio is currently an exception: apart from a tightening of requirements in the form of the proposed breakdown into regulatory retail and other retail exposures, there is to be virtually no change to the application of the current 75% flat risk weight. Yet banks applying the IRB approach have demonstrated on the basis of many years of experience that it is also possible to break down retail exposures into further categories. We would therefore like to submit the following concrete proposals for the treatment of exposures to the retail sub-categories of high net worth individuals, SMEs and auto loans.

1. *High net worth individuals*

The key criteria applied by users of the IRB approach for determining the probability of default are the client's net assets and net income. PDs of wealthy clients and clients with high incomes are significantly lower in statistical terms than those of natural persons with medium to low asset or income levels. In addition, there is normally a positive correlation between PD and LGD. This statistically proven observation is also reflected in the exceptionally low proportion of specific credit risk adjustments in banks' high-net-worth client segment. It is also manifest in the terms and conditions banks offer such clients for (unsecured) loans. Based on the experience of banks using the IRB approach, we consider a risk weight of 20% to be appropriate for wealthy and high-income clients.

2. *Exposures to SMEs*

For the reasons and on the grounds explained in our response to the Basle Committee's first consultative document, we would recommend a risk weight of 50% for SME exposures.¹

¹ GBIC: Comments on BCBS Consultation Paper "Revisions to the Standardised Approach for Credit Risk" (BCBS 307), page 15.

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3. Auto loans

According to para 46, auto loans and auto leases to retail clients will also be risk-weighted at 75%. As recent sample calculations for capital requirements under the IRB approach showed in the QIS on securitisations, realised losses and IRB capital requirements in the retail auto-financing segment are very low. The risk weight proposed for the SA is far too high. One of the reasons for this is that the SA assumes unsecured lending is involved since vehicles are not recognised as collateral. This could cause problems in the future for the securitisation of auto ABS. The standardised approach for securitisations is based on the standard risk weight applied to the securitised exposures under the SA for credit risk. The excessively high risk weights sometimes lead to extremely high capital requirements for securitised positions under the standardised approach to securitisation. Should the external ratings-based approach to calculating risk weights for securitised exposures no longer be available after the securitisation framework has been revised, there will be serious implications for the auto ABS securitisation segment. As a result of the extremely high capital requirements based on excessively high standard risk weights, it will no longer be possible to sell them to banks. Unlike in the US, banks are the major purchasers of auto ABS. With this in mind, we strongly recommend a lower risk weight for secured auto loans and leases. We consider 20% appropriate.

Real estate exposure class

Preliminary remarks

A major point of criticism is the proposed capital requirements for property loans, especially the proposed risk weights for commercial real estate exposures. We are also critical of the fact that it is no longer possible to apply a general risk weight of 35% to residential real estate exposures.

In our eyes, the Committee's proposals fail to take account of various special features of national property markets. We call, in particular, for the retention of national discretion to allow preferential risk weights if the country's property markets and lending guidelines justify much lower risk weights. Take the German property market, which, unlike other national markets, is characterised by long maturity loans and fixed interest rates. Since real estate lending to retail clients and SMEs represents the core business of many small banks, these banks would be hit disproportionately hard by the proposed new requirements. To avoid this and an ensuing credit crunch, a sense of proportion is needed and risk weights should be kept at their current level. Otherwise, there will be ramifications for the entire economy.

Paras 49-52 General requirements

It should be made clear that second liens are also an effective mitigant of credit risk for the lending bank and therefore also meet the minimum requirements for collateral to qualify as a claim over the property under para 50.

Real estate loan splitting

Footnote 44 to para 52 states that different loans secured by the same property should be added together to calculate the LTV ratio. This could be interpreted in such a way as to render real estate loan splitting unfeasible. Real estate loan splitting is a widespread practice in Europe and means the splitting of the total loan into a secured and an unsecured part. We are firmly opposed to a ban of this kind. It would be easy to circumvent by means of "true" real estate loan splitting, but this would result in higher loan processing costs, which would have to be borne by the borrower. In addition, the transition from one LTV

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bucket to the next produces a sudden "jump" in capital requirements (cliff effect). This can be avoided by real estate loan splitting.

Example of real estate loan splitting in Europe

Loan: €100,000

Value of the property: €85,000

The €100,000 loan is split into a real estate loan of €68,000 (80% of €85,000) and an unsecured loan worth €32,000. The €68,000 loan would be assigned a preferential risk weight of 35% and the unsecured loan a risk weight of 75%, for example, making an average risk weight of 48%.

This would make it unnecessary to have different LTV categories since real estate loan splitting automatically causes the average risk weight to increase. The smaller the proportion of the real estate loan (with an LTV of $\leq 80\%$, for example) with its privileged risk weight (35%, for example), the greater the increase in the average risk weight. We therefore recommend having only one preferential risk weight and continuing to permit real estate loan splitting.

An added advantage would be to better reflect collateral agreements where there is no direct link between properties and loans. Footnote 44 explains how to calculate the LTV ratio if one property serves as collateral for several loans granted by one bank. But it is not clear how to proceed if several loans are secured by several properties. Calculating the LTV ratio by adding together the amounts of the loans and the value of the properties would overstate the risk involved, especially if the property also served as collateral for other loans to the client (broad statement of collateral purpose). It is not clear to us what LTV ratio is supposed to be used if two or more properties are available to secure a loan and different ratios consequently exist for one exposure. We would appreciate clarification of this point.

Example

Loans: €310,000 (real estate loan)
 €320,000 (real estate loan)
 €25,000 (overdraft facility)
 €655,000

Security: €300,000 (property 1)
 €400,000 (property 2)
 €700,000

If only the real estate loans were secured by the property, the LTV ratio would be 90%, giving a risk weight of 45%. The average risk weight for a retail client is in this case 46%. If, however, the property also served as collateral for the overdraft facility, the LTV ratio would rise to 94% and the average risk weight for all loans would rise to 55%. This means the additional collateral puts the bank in a less favourable position.

Real estate loan splitting can prevent that. In the above example, a real estate loan could be agreed (e.g. of €560,000 with an LTV ratio of max. 80% for the preferential risk weight) and a 35% risk weight assigned. The remaining unsecured loan of €95,000 would be risk-weighted at 75%, making an average risk weight of 41%. If the current account overdraft facility rose from €25,000 to €75,000, the additional security would produce an LTV ratio of $>100\%$, and thus a 75% risk weight for the entire exposure.

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Should the Committee decide to retain the proposed approach with several LTV buckets, the LTV calculation method should at least be modified so that banks are not forced to restrict collateral agreements to real estate loans only, with the result that they have to accept a less favourable collateral situation for all loans, and thus a higher risk, simply so that they can apply a lower risk weight. We believe it would make good sense to restrict the addition of collateral in the form of real estate for the purposes of calculating the LTV ratio to selected (real estate) loans only, i.e. loans for the purpose of funding the property or for which the bank wishes to use the property as collateral. This need not necessarily be the same as the additional rights from the collateral agreements.

We do not understand the procedure for taking account of senior liens held by other banks. According to footnote 45, exposures from loans secured by senior liens have to be added to the loan amount, so the numerator of the LTV ratio will increase. In our view, however, the senior lien should be used to reduce the value of the property, i.e. the denominator of the LTV ratio. This would also make it unnecessary to obtain information about the amount of loans from another bank.

Example: value of the property = €150,000

	Lien	Loan	LTV (CP)	LTV (new)	RW (CP)	RW (new)
Other bank	€90,000	€90,000	60%	60%	30%	30%
Own exposure	€30,000	€30,000	80%	50%	35%	30%

In this example, the bank's own exposure is secured by a junior lien. If, unlike in the procedure described in footnote 45, the denominator were reduced by the amount of the senior lien, the result would be a risk weight that better reflected the actual risk.

LTV risk factor

It would be desirable to establish a single, worldwide definition of "prudent value" within the meaning of para 52 in the event that the Committee does not follow our recommendation for retaining national discretion to allow preferential risk weights if the country's property markets and lending guidelines justify much lower weights. This term needs to be fleshed out in far more detail than at present. Depending on how "prudent value" is interpreted, e.g. on the basis of the mortgage lending value as defined in Germany or in other countries with a definition of the term (highly conservative compared to countries using market values as a basis), there are likely considerable differences worldwide in how this requirement is applied. Comparable properties/loans would thus have significantly different LTV ratios, and different capital requirements as a result. Conversely, properties/loans which were not comparable from a risk perspective might generate identical capital requirements. This is doubtless not what the Basel Committee has in mind and is a major shortcoming of the new proposal, which will not result in an adequate differentiation of risk.

Nor is it appropriate always to calculate capital requirements on the basis of the LTV ratio at origination unless national supervisors require adjustments over the life of the loan. We do not understand the reason for granting national discretion over this point. There should instead be a general requirement to adjust LTV ratios at appropriate intervals over the life of the loan in response not only to possible reductions in the "loan components" but also to changes in "value components".

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Imbalances of this kind would need to be eliminated by national or European rules. To avoid placing countries using the mortgage lending value concept at a disadvantage, these countries should be explicitly permitted to base calculations on the mortgage lending value or the market value.

In addition, consideration should be given to the idea of permitting banks to take account of more than one risk factor when calculating capital requirements. This could help to improve risk differentiation in this highly important exposure class. Possible second risk factors might be:

- historical loss rates at country or bank level
- qualitative factors which characterise low-risk exposures along the lines of those used in the area of securitisations (e.g. for residential property: self-occupancy, full recourse, annuity mortgage – i.e. not interest only); lower risk weight conditional on all criteria being met
- past-due intervals prior to default (no past-due payments: reduced risk weight; 0-30 days past due (dpd), 31-60 dpd, 61-90 dpd: progressively higher risk weights)

These proposals would need to be fleshed out further, possibly in cooperation with the banking industry.

Another problem is that the risk weights derived from the LTV ratios are often too high. LTV ratios of up to 100% generate risk weights of between 25% and 55%. Where LTV ratios are above 100%, by contrast, the risk weight of the borrower is also included in the calculation. Unless some of the qualitative requirements are met, the risk weights will increase and may be between 120% and 150%. On top of that, risk weights will also be higher if the repayment of the loan essentially depends on cash flows generated by the property.

The risk weight for a rented flat with an LTV ratio of up to 60%, for instance, will rise to 70% (from possibly only 35% at present). The picture for rented commercial property is similar: the risk weight under the Basel Committee's proposals would double from 50% at present to 100%. We do not understand the rationale behind such rises and call on the Committee to revisit the whole issue of risk weights for real estate exposures and refrain from prescribing such exorbitant increases.

Paras 53-56 Residential real estate exposures

According to para 55, exposures which do not meet the requirements of para 50 are to be assigned a risk weight of 100% or the risk weight of the counterparty, whichever is the higher. We would recommend assigning a risk weight of 75% to exposures of this kind to private individuals and 85% to exposures to SMEs. Otherwise, there will be a lack of consistency with para 104, which states that no collateralised exposure may receive a higher capital requirement than an equivalent uncollateralised exposure. According to footnote 48, moreover, residential real estate exposures to individuals and SMEs with an LTV ratio of above 100% should receive risk weights of 75% and 85% respectively. It is therefore only appropriate to permit these risk weights for the exposures mentioned in paras 53-56 as well.

Para 56 sets out the risk weights for residential real estate exposures where repayment depends on cash flows generated by the property. Footnote 50 exempts loans to cooperative housing associations from this treatment. This exemption should also be extended to publicly funded housing associations. In Germany, public housing associations are major providers of rented accommodation. Increasing the risk weight from 35% at present to the proposed minimum of 70% would seriously call the business model of these housing associations into question. We believe an exemption would be justified from a risk angle, too, since the cash flow dependency is never based only on cash flows from a specific property but on cash flows from diversified property holdings.

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Paras 57-60 Commercial real estate exposures

Our concerns about para 55 also apply to para 59: in addition to the problem of inconsistency with para 104, footnote 51 states that commercial real estate exposures to individuals and SMEs with an LTV ratio of above 100% should receive risk weights of 75% and 85% respectively. It is therefore only appropriate to permit these risk weights for the exposures mentioned in paras 57-60 as well.

Banks are required to demonstrate the independence of commercial real estate exposures from cash flows by showing that the repayment of the loan does not materially depend on cash flows generated by the property securing the loan. In contrast to the requirements of the CRR, rent and lease payments are explicitly mentioned as the source of such cash flows (para 60). Under the CRR, evidence is currently provided by means of the "Hard Test" or by demonstrating third-party usability. In future, individual evidence will be required. This could be provided if one of the following criteria is met; either of them should be sufficient to demonstrate non-dependency on cash flows.

1. The commercial property is used by the borrower.
It can be assumed in this case that the borrower also has other sources of income for servicing the loan. If, in addition, the property is capable of being used by a third party, non-dependence on cash flows from the property should be assumed.
2. The commercial property is let out (but not used) by the borrower
Non-dependence on cash flows can be assumed in the event of a sustainable debt service coverage ratio. Non-dependence should be assumed in any event for the period of the loan which coincides with the period of the rental contract.

Para 61 ADC exposures

ADC exposures are loans to fund the acquisition, development or construction of property – in other words, classic property development finance where the subsequent sale of the property or ability to generate future cash flows is uncertain. These exposures are to continue to receive a risk weight of 150%. That is far too high. Property development loans, for example, are almost always dependent on the status of advance sales, i.e. the developer has to demonstrate the marketability of the property in the form of advance sales before the loan can be drawn on and the construction phase can begin at all. It is therefore not correct to assume that sales are uncertain. On top of that, residual lending is invariably limited to below 100% of the lendable value both in the land acquisition and in the construction phase; in the construction phase it is normally below 75%. In the land acquisition phase, the existence of building rights has to be ensured. Lending decisions do not depend exclusively on the specific project in question, but also on the creditworthiness of the developer.

Against this backdrop, we do not believe the sale or ability to generate cash flows can be considered uncertain as a matter of course and consider a 150% risk weight much too high. For corporate exposures, a risk weight of 150% is assigned only on default, meaning that, as things stand, the Basel Committee is equating ADC exposures with default. We believe ADC exposures should be assigned a risk weight of 100% until the completion of the project.

Should ADC loans be purely speculative in nature, e.g. non-recourse financing together with a high lending amount and no analysis of marketability, higher risk weights could always be required in these exceptional cases. But these higher risk weights should always be lower than those for defaulted exposures (150%).

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Add-on risk weight to certain exposures with currency mismatch

Paras 62-63

We basically agree that an add-on is justified for inadequately hedged exposures with currency mismatches on the grounds of the higher risk of the borrower's default. The 50% add-on proposed in para 62 is too high, however, and should be reduced. In the corporate exposure class, which primarily contains unrated exposures, this will lead to a risk weight of 150%. Exposures with a currency mismatch will consequently receive the same risk weights as defaulted exposures. This is not justified, in our view. It should also be borne in mind that the value of a property does not change as a result of a currency movement. This is another argument in favour of reducing the add-on.

In our view, the scope of this requirement should cover only retail and residential real estate exposures and exposures to SMEs within the meaning of para 37. Exposures to subordinated debt and equity holdings should therefore also be excluded.

When exposures to corporates and commercial real estate are involved, it can be assumed that the firms in question have sufficient expertise to manage their FX risk. Since these borrowers are not at greater risk of default, it should be possible to assume that a natural hedge within the meaning of para 63 is in place.

Our understanding of what constitutes a hedged exposure is as follows: the hedge always relates to the counterparty's risk of default and consists of an action or failure to take action by the client (about which the bank may have no knowledge). The hedge does not relate to the bank's FX risk from an FX exposure (in other words, a client's unhedged FX risk leads to a higher risk of default for the bank). Banks are already required under the market risk regime to set capital aside to cover FX risk in the banking book, and we are firmly opposed to the idea of duplicate capital requirements. We believe clarification of this point in the text of the standards would make good sense.

Like in the old market risk capital requirements for currency risk, the FX add-on should not apply to closely connected currencies, or at least the add-on should be lower in such cases. If there is a high correlation between two currencies, the borrower is not at greater risk of default as a result of a currency mismatch.

The Basel Committee proposes that calculations of currency mismatches should be based on the currency of the borrower's main source of income. This is not practicable, in our view. We would suggest using the currency of the borrower's country of residence instead.

Off-balance sheet items

We welcome the lowering of the credit conversion factor (CCF) compared to the first consultative document, but nevertheless feel the proposed CCFs are still too high. As explained in our response to the first consultative document, most off-balance sheet items are associated with lending to retail clients and SMEs. Increasing the CCF will therefore have an adverse effect on the readiness to lend or will lead to a tightening of the terms and conditions for fixed-term credit commitments. We are particularly critical of the fact that the new method of determining CCFs is much more complex than at present and that there is no longer any provision for applying a 0% factor.

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The CCFs for undrawn credit commitments to corporates under para 66 remain excessively high. Corporate SMEs would also be affected. The proposed CCFs would have a particularly adverse effect on capital requirements for credit facilities valid until further notice. These currently receive a 0% risk weight and would in the future be assigned a yet undefined weight of between 50% and 75%. It is absolutely essential to reduce the CCF for facilities valid until further notice. Otherwise, banks will have no alternative but to significantly curtail existing credit lines and charge companies for the associated cost of capital. A combined scenario is the most likely outcome. This would have a negative impact on the ability of firms in the real economy to access funds swiftly.

We would therefore suggest differentiating between retail and corporate commitments. A 5% CCF should be applied to retail commitments, and a 10% CCF to corporates since these companies, owing to the close relations they have with their bank, are especially dependent on inexpensive credit lines valid until further notice. This would still represent a significant – though more manageable – increase in the CCF.

A 50% CCF should be applied to the other off-balance sheet items covered by para 66. Should the Basel Committee nevertheless decide on the application of a flat 75% CCF, we consider it imperative to at least apply a lower, 50% factor to credit lines with an original maturity of up to one year.

We do not understand the rationale in para 69 behind applying the more favourable CCF only to unconditionally cancellable retail commitments. The lower CCFs should be applied to all exposure classes. As far as we are aware, banks using the advanced IRB approach have detected no significant differences during their annual review of CCFs between the way retail and corporate clients make use of credit facilities.

Defaulted exposures

Specific provisions should continue to lead to a reduction in the risk weight for defaulted exposures (para 77). At banks using the IRB approach, specific provisions are normally sufficient to cover the expected loss. At banks using the SA, provisions are sometimes even considerably higher than at IRB banks because they are frequently equivalent to the full amount of the unsecured portion of the exposure regardless of the possibility of recovery after default. Uncertainty therefore exists only as to the amount of the collateral value that can be realised. Accordingly, the IRB approach requires banks to calculate the unexpected loss on a defaulted exposure as the difference between the LGD and the best estimate expected loss multiplied by a factor of 12.5. Given that, once an exposure is in default, there is no longer any uncertainty about the PD, but only about the amount of the LGD, specific provisions of 20% or more should continue to result in a risk weight of 100% being applied. This approach is also justified when – as is normal practice – the provisions approved in the last annual financial statements reduce the exposure to which the risk weight is assigned since the risk of unexpected loss is significantly lower in the event of a provision of at least 20% and the risk associated with the level of the LGD only exists for the portion of the exposure for which no provision has been made.

It should be made clear that a risk weight of 100% should always be applied to defaulted exposures which are secured by residential property (para 78) and meet the minimum requirements of para 50 (meaning they do not depend on cash flows generated by the property).

It is not clear why certain exposures secured by residential property should be risk-weighted net of specific credit risk adjustments at 100% while a risk weight of 150% is envisaged for all other exposures

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secured by residential property and exposures secured by commercial property net of specific credit risk adjustments. This implies that loan loss provisioning for residential real estate exposures where repayments do not materially depend on cash flows generated by the property is somehow more "precise" than for other exposures secured by residential and commercial real estate. In our view, there should be no differentiation between the two: defaulted exposures secured both by residential and by commercial property should be risk-weighted net of specific credit risk adjustments at 100%.

Credit risk mitigation techniques

The consultative document appears to assume that real estate exposures are invariably secured by property alone. It is common practice at diversified banks, however, that loans are collateralised with various different types of securities, particularly in the area of corporate finance. We assume that, in such cases, the types of securities other than property will continue to be eligible as collateral and can be included in calculations.

As part of the planned review of the internal ratings-based approach, the Basel Committee is considering no longer permitting the modelling of several exposure classes and requiring the application of the standardised approach instead. When it comes to the recognition of credit risk mitigation techniques, it needs to be ensured that collateral eligible under the IRB approach can continue to be recognised as mitigating credit risk even if the collateralised exposure has to be handled under the SA. Otherwise, banks using the IRB approach would be additionally disadvantaged without any justification from a risk perspective. Collateral eligible under the IRB approach could be recognised in the SA in the form of reduced risk weights, for example – along the lines of the procedure for exposures secured by real estate – or by adjusting the assessment base with fixed factors.

An additional column should be added to table 14 in para 149 for reduced haircuts for STC (simple, transparent and comparable) securitisations. This would be justified because structural risks and the risk of mis-valuation are significantly reduced. The Basel Committee ran a consultation until 5 February this year on reducing capital requirements for STC securitisations (BCBS consultative document of November 2015: "Capital treatment for simple, transparent and comparable securitisations").

Yours sincerely,
on behalf of the German Banking Industry Committee,
Association of German Banks



Dirk Jäger
Member of the Management Board



Dr. Uwe Gaumert
Director