KfW Bankengruppe, Postfach 111141, 60046 Frankfurt am Main

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Response to the BCBS Consultative Document "Simplified alternative to the standardised approach to market risk capital requirements" (BCBS d408)

Date: 27/09/2017

Jochen Leubner
Our ref.: Lbn
Phone: +49 69 7431 2569
Fax: +49 69 7431 66 1284
jochen.leubner@kfw.de

Dear Sirs,

KfW very much appreciates having the opportunity to submit this comment letter to the above mentioned consultative document issued by the BCBS for comment on June 29, 2017 (the "CD").

After providing some background information on KfW itself, in particular its legal status under relevant regulations, we would like to make a general observation on the risk weights for Delta CSR non-securitisation sensitivities proposed under the simplified alternative to the standard approach to market risk capital requirements and, in this context, a specific comment on the treatment of risk exposures to certain public sector entities. We respectfully request the BCBS to take our comments into due consideration when finalizing the work on the subject matter.

1. Background on KfW

KfW was established in 1948 by the Administration of the Combined Economic Area, the immediate predecessor of the Federal Republic. KfW is a German public law institution (*Anstalt des öffentlichen Rechts*) organized under the Law Concerning KfW (*Gesetz über die Kreditanstalt für Wiederaufbau*, or "KfW Law"). The Federal Republic holds 80% of KfW's equity capital and the German federal states hold the remaining 20%.

As a German state-owned promotional bank, KfW serves domestic and international public policy objectives of the German Federal government, primarily by engaging in various promotional lending activities. KfW's lending activities include domestic financing, primarily made through commercial banks, including, in particular, loans to small and medium-sized enterprises and housing-related loans, export and project finance through KfW's wholly-owned subsidiary KfW IPEX-Bank GmbH and development finance for developing and transition countries.

The KfW Law expressly provides that the Federal Republic guarantees all existing and future obligations of KfW in respect of money borrowed, bonds and notes issued and derivative transactions entered into by KfW (KfW Law, Article 1a). Under this statutory guarantee (the "Guarantee of the Federal Republic"), if KfW fails to make any payment of principal or interest or any other amount required to be paid with respect to any of KfW's obligations mentioned above, the Federal Republic will be liable at all times for that payment as and when it becomes due and payable. The Federal Republic's obligation under the Guarantee of the Federal Republic ranks equally, without any preference, with all of its other present and future unsecured and unsubordinated indebtedness.

KfW is a public sector entity within the meaning of Paragraph 58 of the Basel II framework and claims on KfW may be treated as claims on the Federal Republic in accordance with Paragraph 58 of the Basel II framework[1] due to the Guarantee of the Federal Republic, and a zero percent risk weight may therefore be assigned under the standardized approach for calculating capital requirements for credit risk of the Basel II framework. Further, due to both its public sector entity status and the zero percent risk weight under the standardised approach for credit risk, marketable securities issued by KfW represent claims that are generally considered level 1 assets in the stock of high-quality liquid assets ("HQLA") under paragraph 50 (c) of the Basel III liquidity coverage ratio ("LCR") requirements.[2]

Under European legislation implementing the Basel II and III frameworks, KfW is similarly treated as under the Basle rules. KfW is a public sector entity as defined in Article 4(1)(8) of the Capital Requirements Regulation (the "CRR").[3]

---

[1] Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version (BCBS 128)
[2] Basel III: the Liquidity Coverage Ratio and liquidity risk monitoring tools (BCBS 238)
[3] Regulation (EU) No 575/2013 of the European Parliament and of the Council of June 26 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012

Exposures to KfW resulting from, e.g., holdings of bonds or notes issued by KfW may be treated like exposures to the Federal Republic due to the Guarantee of the Federal Republic according to Article 116(4) CRR. The risk weight assigned to these exposures to KfW under the standardized approach for calculating capital requirements for credit risk is thus zero percent. Further, bonds and notes issued by KfW are generally considered level 1 HQLA under EU legislation implementing the Basel III LCR requirements.[4]

2. Comments on the Consultative Document

2.1 General observation on the risk weights for Delta CSR non-securitisation sensitivities

We note that the BCBS proposes a less granular approach for purposes of assigning buckets and risk weights to Delta CSR non-securitisation sensitivities under paragraphs 226 to 229 of the simplified alternative to the standardised approach as compared to the standardised approach itself.[5] Furthermore, risk weights themselves are generally substantially higher across all buckets of sensitivities or risk exposures under the simplified alternative than under the standardised approach. Finally, the relative increase in risk weights under the simplified alternative compared to the standardised approach varies significantly across the (sub-)buckets.

For example, while the risk weight for investment-grade sovereigns including central banks and multilateral development banks in bucket 1 is 1.0% in the simplified alternative, it amounts to 0.5% in the standardised approach, i.e. an increase of 100%. For investment-grade local governments, government-backed non-financials, education and public administration of the same bucket, the risk weight in the simplified alternative is, however, five times higher than the one in the standardised approach (5.0% vs. 1.0%). For investment-grade financials, including government-backed financials, the risk weights are 10% vs. 5%, again a 100% increase.

At the same time, and from our point of view surprisingly so, the changes in risk weights, in relative terms, for the high-yield equivalents to the before-mentioned

[4] Article 10(1)(c)(v) of Commission Delegated Regulation (EU) 2015/61 of 10 October to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirements for Credit Institutions

[5] Cf. paragraphs 82 to 84 of the BCBS Standards „Minimum capital requirements for market risk" (BCBS d352)

risk exposures are lower than for the respective investment-grade risk exposures when comparing the simplified alternative with the standardised approach. For example, for investment-grade sovereigns, as outlined in the preceding paragraph, the risk weight increases by 100% when comparing the simplified alternative with the standardised approach. However, for high-yield sovereigns the relative increase in risk weights amounts to less than 100% (5.0% vs. 3.0%). The same is true for local governments, government-backed financials, education and public administration.

As a result, we are concerned that the simplification inherent to the simplified alternative comes at too high a cost, at least with regard to the risk exposures mentioned above, and may thus adversely impact the ability of smaller institutions that may wish to opt for the simplified alternative to actively trade these securities and thereby contribute to the overall liquidity of these assets, to the very detriment of all market participants active in these securities – investors (banks and non-banks), issuers and intermediaries alike.

We therefore kindly request the BCBS to review the methodology for deriving risk weights for Delta CSR non-securitisation sensitivities in the simplified alternative and ensure consistency within each of the two approaches and across the two approaches.

2.2 Treatment of public sector entities for purposes of assigning risk weights to Delta CSR non-securitisation sensitivities

We note that the classification of buckets in the market risk framework, both in the standardised approach and the simplified alternative, is different to the one applicable to the exposures classes in the credit risk framework. There may be good reasons for that in general, e.g. with respect to the significantly higher degree of granularity for corporate risk exposures. However, we are concerned that the category of non-central government public sector entities that may be treated as sovereigns in accordance with paragraph 58 of the Basel II framework is not explicitly captured in the table under paragraph 226 of BCBS d408 which may lead to an inadequate treatment of exposures to these entities by banks applying the framework.

As outlined in more detail below, we think that it is appropriate and consistent with other relevant BCBS standards, notably the credit risk capital requirements and the LCR requirements, that non-central government public sector entities that can be treated as sovereigns in accordance with paragraph 58 of the Basel II framework be treated as sovereigns for purposes of the market risk capital requirements. We would appreciate that a clarification in the BCBS's market risk frameworks – both in the standardised approach and in the simplified alternative – that the term sovereign for these purposes includes non-central government public sector entities provided that such non-central government public sector entities, at national discretion, are treated as a sovereign in the standardised approach for credit risk.

It is our understanding that the credit spread risk factor shall capture the risk that the credit spread of an entity, notably an issuer of debt securities, changes over time, and thus the price or value of the debt securities issued by this entity changes over time. The core component of the credit spread at any time, in our opinion, is the average credit assessment by the market of the credit risk that such issuer represents expressed as a yield differential against some type of credit-risk-free rate such as, traditionally, a Triple-A-rated government bond yield or fully cash-collateralised swap rates. From this point of view, changes in the credit spread of an issuer are simply changes in market participants' assessment of the credit risk that the issuer represents over time. Therefore, the credit spread risk related to debt securities of an issuer is kind of the first derivative of the credit risk that the issuer represents, as captured by the credit risk framework, over time. As a result, where the credit risk of a non-central government public sector entity is so closely related to the credit risk of the sovereign due to an appropriate guarantee provided by the relevant sovereign for the non-central government public sector entity, and as acknowledged in the Basel II credit risk framework, there is a strong basis that such entities should be treated as the sovereign that provides the guarantee for the non-central government public sector entity under the market risk framework.

However, apart from the pure credit component, observed credit spreads may also reflect current market conditions with respect to supply and demand for a particular security at a certain point in time, i.e. whether a security is liquid and thus actively traded or not. In particular, credit spreads of illiquid debt instruments of an issuer may include a yield premium compensating for the risk that the price of that security does not change over time in line with the price of the risk-free reference asset due to its relative illiquidity. Over the lifetime of the security, the liquidity pattern of that instrument may change, which in turn may impact the observed "credit" spread of that instrument against the risk-free reference rate. But again, the BCBS has acknowledged in its work on the LCR requirements that there are classes of assets that share the same characteristics in terms of liquidity, namely marketable securities representing claims on or guaranteed by sovereigns, central banks, public sector entities and multilateral development banks that are assigned the same risk weight under the Basel II standardised approach for credit risk.[6] Therefore, where both the assessment of the credit risk as well as the liquidity risk is the same under applicable Basel standards for a sovereign and a non-central government public sector entity, equal treatment should be granted to these exposures under the credit spread risk regime in the market risk framework, too.

Based on this analysis we respectfully request the BCBS to clarify in its market risk capital requirements framework – both for the standardised approach and the simplified alternative – that the term "sovereign" includes those non-central government public sector entities that may be treated as sovereigns under the standardised approach for credit risk of the Basel II framework, e.g. by attaching a footnote to the term "sovereign" in the table in paragraph 229 of the simplified alternative to this effect.

We thank you very much for taking our comments into due consideration.

Sincerely,

KfW

/s/ DR FRANK CZICHOWSKI	/s/ KATRIN WIEBUS
Name: Dr. Frank Czichowski Title: Senior Vice President and Treasurer	Name: Katrin Wiebus Title: First Vice President

[6] As outlined above, non-central government public sector entities will share the same risk weight as their sovereign where the conditions of paragraph 58 of the Basel II framework are fulfilled, e.g. due to the existence of an appropriate guarantee provided by the sovereign for the non-central government public sector entity.