

Opinion

of the Verband Deutscher Bürgschaftsbanken (Association of German guarantee banks) on the Consultation Paper of the Basel Committee on the Revisions to the Standardised Approach for Credit Risk

BCBS: 2nd Consultation Standardised Approach

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I. Preliminary remarks

Guarantee banks assume guarantees for the financing of promising projects of entrepreneurs, small and medium-sized commercial enterprises and freelance professions. The security provided by the guarantee banks represents full-value collateral for all banks and reduces the capital adequacy requirements in favour of credit institutions. The activities of the guarantee banks are only possible through the partial government counter-guarantee for the guarantees issued. The emphasis here is on promoting and preserving the SME sector. The activities of the guarantee banks are not profit-oriented; dividends are excluded also. German guarantee banks are exempt from corporation tax in accordance with § 5 (1) No. 17 KStG (German Corporation Tax Law).

II. Comment on the draft

We are grateful for the opportunity to submit our opinion in the context of the second consultation process on the revision of the standardised approach for credit risk. We greatly welcome the fact that the comments from the first consultation have been considered in part. The second consultation document again pursues the objective of formulating the standardised approach for credit risk in a more risk-sensitive way while at the same time keeping ease of application at the forefront of the review. The basic objective is, furthermore, not to increase capital requirements for credit institutions.

We take a critical view of the stipulated objective of the second draft in the form presented, however, and assess the changes, despite partial consideration of the comments put forward in the first consultation, as a departure from the previous policy thoughts of the standardised approach for credit risk. We see overall in the draft a substantial tightening of existing requirements, which is in part not justifiable, but which represents far-reaching consequences for the financing of the SME sector. We would like to stress that the current standardised approach for credit risk has proved a success in terms of content and that a complete overhaul, even in light of the financial and economic crisis, is not justifiable for smaller institutions.

III. The consultation paper in detail

1. Counterparty risks for banks

The use of external ratings for the calculation of risk weights under the standardised approach shall according to the proposals in the second draft still be limited in that the credit ratings used shall be checked for plausibility through a due diligence process. The precise content requirements for this due diligence, however, are not described in sufficient detail. The extension in the form of an annual review of the risk profile and the characteristics of each counterparty we cannot comprehend. Generally, the risk of debt is reflected accordingly by the rating of a recognised rating agency. The rating agencies have extensive information on the financial position of the financial institution in question and assess this continuously based on a forward-looking method. It is not evident to us that the aspects envisaged as part of the consultation document represent a significant qualitative added value compared to the previous practice. We would also like to emphasise that this process represents, especially for small credit institutions, a considerable additional burden that is disproportionate to the value to be drawn from this.

State guarantees to banks shall in future no longer be considered in the use of credit ratings. We feel this is not appropriate, as for one the revision of counterparty risks for states is to be dealt with in the context of a later review.

Against this background, we consider it appropriate to maintain the concept of external ratings in the standardised approach for credit risk.

The second draft provides for a complete departure from the use of the country of domicile method. The draft stipulates that banks without ratings shall be divided into three classes, in which compliance with the respective regulatory minimum requirements shall be considered.

We do not consider this proposal appropriate, as the use of the country of country of domicile method has proved itself over many years. We expressly support the view that, if no external rating is available, the risk weight for counterparty risks for banks should continue to be determined in accordance with the country of domicile method. Under this method, the risk weight for counterparty risks is derived from the credit rating of the country in which the respective institution has its registered office. The country of domicile hereby reflects the regulatory framework conditions

in the respective country and allows conclusions to be drawn about the robust and resilient supervisory regime in the relevant country of domicile.

Maintaining the country of domicile method is particularly valid given the fact that the counterparty risks of states are not supposed to be under review with the draft submitted by the Basel Committee.

Furthermore, we view the general tightening to be questionable and not practical. These adjustments do not take into account the development of the banking industry in the context of the modernisation measures of Basel III. The new regulatory developments have been reflected in the stability of the institutions. There does not seem to be any justification to increase risk weights generally at this stage.

2. Counterparty risks for businesses

According to the present consultation document, the plan in respect of counterparty risks for the corporate exposure class shall be, similarly to the procedure for counterparty risks for banks, to restrict the use of external ratings of the borrowing business concerned to the extent that any possible rating existing shall be checked by means of a due diligence assessment.

The risk profile and characteristics of the counterparty shall be investigated at least annually. Particularly for small credit institutions, the data acquisition – which could essentially prove to be very difficult in some cases - represents an extreme amount of effort. Unrated exposures of the corporate exposure class shall continue to receive a risk weight of 100%.

a.) Specifically: no less favourable treatment of SMEs

The consultation draft reveals a less favourable treatment of SMEs compared to large companies. We are extremely critical of this. Generally speaking, the SME sector plays an important role in the EU economy. Small and medium enterprises are financed in particular by loans, because the offer of financing options for this group of companies is rather limited compared to the many funding opportunities available to large companies. The financing costs for small and medium enterprises would be increased by the measures proposed in the present consultation paper. Moreover, we see a risk that access to funding will also become more difficult for small and medium enterprises.

b.) Counterparty risks for retail

Regarding the counterparty risks of the retail exposure class, we refer in particular to our opening statement in which we emphasised that the standardised approach for credit risk has proved itself to be successful and there is no evidence of actual

need for adjustment. The retail sector shall in future be divided into "regulatory retail" and "other retail" exposures.

To be assigned to "regulatory retail" the following criteria must be met:

- Borrower must be an individual person or SME
- Exposure must come from the product types: revolving credit, credit line, private credit and leasing as well as line of credit and commitment for micro-enterprises
- Total amount owed by a debtor must not exceed EUR 1 million
- The aggregated loans of a debtor may not exceed 0.2% of the "regulatory retail" portfolio

We would like to stress at this point that it is imperative that the objective applicability refer to small and medium SMEs. The definition of SMEs corresponds to the definition of the IRB approach.

Similarly, the consultation paper outlines that the granularity criterion of 0.2% of the retail portfolio, to which a benchmark has hitherto been attached, shall now have mandatory application. This point in particular seems very problematic to us, as this would mean that loan amounts would decrease. Particularly for small banks with a local customer base, this represents a considerable financial obstacle.

It is absolutely imperative that counterparty risks of businesses can be allocated to the "regulatory retail" counterparty risk area up to an exposure level of EUR 1 million.

Especially in the field of retail business we consider simple methods of low complexity for risk assessments to be crucially important. It is in this area in particular that the cost of borrowing and the expenses associated with investigations must be kept within limits so as to be able to represent proper financing for small and medium enterprises.

3. Off-balance sheet exposures

Among the further weaknesses identified by the Committee in relation to the standardised approach for credit risk is the calibration of credit conversion factors. The assessment of off-balance sheet items within the context of credit conversion

factors is also to be tightened up in the second draft, if the comments from the first consultation have been taken into consideration positively. Agreements that are unconditionally cancellable and due at any time shall be assessed with a risk weighting of 10-20%. All other agreements are assigned a risk weight of 50-75%. In the previous standardised approach for credit risk, the assessment depended on

the term and ranged from between 20% to 50%. This consultation paper proposes a tightening here. We do not consider this significant tightening to be appropriate. The end result will mean a substantial increase in financing costs for small and medium businesses. The possibilities of capital relief for banks through the acceptance of agreements in the area of off-balance sheet positions would thereby be significantly restricted. We do not consider this change in approach to be appropriate.

4. Credit risk mitigation techniques

In future, recognised guarantors are to be significantly restricted in the context of credit risk mitigation techniques in such a way that protection sellers will only be recognised if they have been assigned a better risk weight than the protection-buying institution. We advocate keeping the existing arrangements as they are, as these can be applied in a practice-oriented manner. Detailed requirements for hedging instruments are already provided. Any further tightening, particularly of recognised guarantors, would not be appropriate.

5. Disclosure

The changes indicated in the credit risk standardised approach are expected to bring with them extensive changes in the area of disclosure. This applies for example for the exposure classes and also for the information that will be required for the due diligence measures to supplement the ratings. These considerations remain for the time being unconsidered.

6. Implementation period

The period of implementation for the proposed changes in this consultation document remains questionable. We would like to draw particular attention to the specifics of small credit institutions who given their reduced resources require a significantly longer preliminary phase than is the case for large credit institutions.

Moreover, the technical preconditions associated with the requirements shall need a corresponding implementation period, which shall require a longer-term preparation. For an implementation of the requirements, the entire framework data must be clearly established. We ask that you consider this with regard to the further development.

7. Scope of application

The regulations of the Basel Committee exert their effect directly on internationally active banks. Their application with respect to small credit institutions with a main focus of activity at national level remains open. In principle, the consultation paper provides for a possible extension of said regulations, meaning that an extended ripple effect on European regulations appears likely. Here, however, a clarification is necessary as to the extent to which Member States may extend and/or be allowed to adjust in certain areas the proposed regulations for non-internationally active businesses.

8. Grandfather policy

Finally, the consultation document contains no statement regarding the procedure for the assessment of positions that have been transferred prior to the amendment by the consultation document. Here a grandfathering clause is essential. This point is directly related to the implementation deadlines. We assume that both the implementation deadlines and the grandfathering shall be at least seven years for banks not directly within the scope of application.