Comments of the Federal Republic of Germany on the consultation of the European Commission regarding possible further changes to the Capital Requirements Directive (CRD)

Introduction:

Question 1: *What impact would the changes proposed in each section of this paper have on your activities or activities of firms in your jurisdiction, including costs linked to increase in regulatory capital and any other compliance costs?*

At present no assessment of the likely impact of the proposals on “dynamic provisioning” can yet be made since the IASB has yet to publish its exposure draft dealing with the provisioning issue.

The proposals on the treatment of foreign currency denominated loans are not convincing as regards the underlying concept of the capital requirements involved, so that in our view the question of possible costs does not yet arise.

The removal or alteration of national options, especially in the field of mortgage lending for purposes of residence and purchase, could in our view potentially entail considerable direct costs for the credit institutions as a result of additional capital requirements and implementation measures. Account should be taken above all of the indirect costs to the national economy as well which would arise from potentially rising interest costs and decreased growth.

Question 2: *Do you have any views about any aggregate impact of the proposed changes to capital requirements?*

It would appear obvious that the changes in the Capital Requirements Directive which have already been decided, are presently being discussed and have already been announced have considerable impact on the European banking sector. This refers not only to the capital requirements imposed on the institutions, but also inter alia to the fields of large exposures, liquidity, securitisations, internal risk management, disclosure, cross-border activities and remuneration. In view of the comprehensive changes which are needed, above all in light of our experiences with the financial market crisis, it seems inadequate to limit ourselves to estimates of the consequences and open consultations in order to assess the proposed amendments.

In our view, due to the importance of the banking industry for growth and employment, the Commission should as quickly as possible conduct representative impact studies on the quantitative effects of the proposed changes.

Question 3: *What is the optimal timing for these measures? Should their application be sequenced?*

Given the severity of the economic downturn and acknowledging current efforts to address the “procyclicality” of the Basel II supervisory framework, we see a need to avoid new (pro-)cyclical supervisory requirements and to implement changes gradually. Otherwise, there would be a risk of exacerbating or prolonging the economic downturn.

Section 1: Through-the-cycle expected loss provisioning

Question 4: *The Commission services suggest that the through-the-cycle value adjustment should not count as regulatory capital (see ANNEX 1, suggested amendment to Article 57). Do you agree?*

We agree: dynamic provisioning is carried out on the basis of expected losses and/or specific loan loss provisions through the course of the cycle, whereas regulatory capital is meant to cover unexpected losses. This differentiation should be maintained in order to avoid improper "double-counting" of regulatory capital buffers for both expected and unexpected losses.

Question 5: *Should off-balance sheet items be captured under the formula for through-the-cycle expected loss provisioning, given that 'provisions' for off-balance sheet items are not recognised in all relevant accounting standards? Should only assets subject to an impairment test be subject to through-the-cycle expected loss provisioning? (See ANNEX 1, suggested Article 74a (2).)*

It makes sense to include off-balance sheet items (such as lending commitments). As the experiences of the current financial market crisis show, it is these that are drawn on or called in times of crisis.

As we understand it, the second part of the question is aimed at the treatment of credit exposures allocated to trade; positive or negative developments in these exposures, which are priced at fair value, are directly reflected in the market price and are correspondingly recognised in P&L on the balance sheet date. As the fair value also reflects the cyclical development of credit risk in trade, it would therefore seem justifiable to smooth out the trading results over a cycle as well. The question is whether, in addition, supplementary risk provisioning should be set aside. A corresponding regulation has already been introduced in Germany as a “haircut” pursuant to Section 340e (3) of the Commercial Code (Handelsgesetzbuch). To this extent we advocate extending “dynamic provisioning” to trade exposures, particularly as the International Accounting Standards (IAS) make no distinction between realised (eligible for distribution) and unrealised (not eligible for distribution with respect to sustainability) profit contributions. However, realisation of profits should be viewed in isolation from risk provisioning.

Question 6: *At this point, the suggestion is not to include the option for competent authorities to allow internal methods to determine expected losses across an economic cycle. As an alternative to the regulatory approach to calculate counter-cyclical factors, would it be desirable to allow firms' internal methodologies (to be validated by supervisors)?*

We are in favour of not allowing the use of internal models to calculate the level of “dynamic provisioning”, in order to maintain comparability between institutions and do justice to the desire for a level playing field. Allowing internal models would also contradict the precondition stated in the paper that the methodology should be formula-based and largely non-discretionary.

Question 7: *Should the exposure class of Article 86 (i.e. for credit institutions subject to the IRB approach) be used irrespective of the fact that the credit institution may be under the Standardised approach? It may be noted that a mapping between exposures class under the Standardised approach and under the IRB is already used in the prudential reporting system of some Member States. As an alternative, should countercyclical parameters be defined for the 16 exposures classes under the Standardised approach? (See ANNEX 1, suggested Article 74a (1).)*

It seems to make little sense to define countercyclical parameters for the 16 exposure classes under the Standardised Approach, particularly given the difficulties in calculating such parameters. Consequently, we support the use of the six exposure classes in the IRB Approach, especially as some countries already map these 16 exposure classes to the six IRB exposure classes.

Question 8: *Please give your views on the following approaches:*

1) the Spanish model of through-the-cycle expected loss provisioning;

2) a 'simplified' Spanish model.

In particular, we would welcome views on the relative merits of both options in terms of the building up of provisions in a graduated manner over time (See ANNEX 1, suggested Annex IXb).

Compared with the alternative model, the Spanish model is significantly more complex for the institutions, both in terms of data requirements and as regards the associated computational requirements. In this respect, the simplified approach (No 2), which requires significantly less time and effort for data collection and computation, is superior to the Spanish model, especially as Spain can draw on data from a credit register set up around 20 years ago, which is not the case for many other European countries. It is therefore likely to be a lot easier for many countries to meet the data requirements of the alternative approach.

Question 9: *Should new risk categories (as suggested above) be introduced along the lines of the Spanish system or, alternatively, should the current risk categories of the CRD (e.g. credit quality steps in Annex VI) be used? (See ANNEX 1, suggested Annex IXb.)*

We oppose the introduction of new risk categories within the individual exposure classes. Instead, as with the exposure classes (see answer to question 7), we would prefer to use the existing regulations of the CRD (Annex VI).

Question 10: *Is the 'location of the borrower' (as opposed to the booking of the exposure) the right approach, with a view to avoiding regulatory arbitrage? (See ANNEX 1, suggested Annex IXb 2.)*

We agree that the location of the borrower should be the decisive criterion. This is the only way to establish a link to the economic situation in the respective country. If, for example a German bank lends to a firm in Spain, the loan is booked only in Germany.

However, for calculating the "dynamic provisioning" for this loan only parameters that reflect the economic situation in Spain (and not in Germany) should be taken into account.

Question 11: *Will the data to determine counter-cyclical factors be easily available?*

The availability of data to calculate countercyclical factors depends on which methodology is ultimately selected; in this respect, we currently cannot provide a conclusive answer to this question. However, we are interested in keeping both the procedure and the statistical basis as simple as possible.

Question 12: *Please give your views on the methodologies for calculating the through-the-cycle expected loss provisions at consolidated level. (See ANNEX 1, amended Article 73.)*

The rules for the consolidated calculation described in Article 73 seem sensible. Their success will hinge on keeping the underlying methodology simple.

Question 13: *Please give your views on the scope of disclosure requirements for through-the-cycle expected loss provisioning. (See ANNEX 1, suggested amendment to Annex XII (17).)*

The suggested amendments to Annex XII appear suited to ensure that through-the-cycle expected loss provisioning is completely transparent.

Section 2: Residential mortgages denominated in a foreign currency

Question 14: *Do you consider that the risk weights suggested will be effective in discouraging unsafe practices and irresponsible lending in foreign currency denominated housing loans?*

Question 15: *Do you consider a loan to value ratio of 50% or less is sufficient objective evidence that the borrower has sufficient private wealth to withstand currency movements and potentially correlated movements in property prices?*

General remarks on Questions 14 and 15: We are aware that real estate and mortgage markets differ widely in the various EU Member States and that residential mortgages denominated in a foreign currency have led to serious problems in some EU Member States, both for individual borrowers and as regards financial stability. We are therefore in principle open to suitable proposals for regulation in this area.

In our view, in approaching regulation of residential mortgages denominated in a foreign currency, a clear distinction must first be made between the different objectives of consumer protection on the one hand and the motive of financial stability. Secondly, obvious opportunities for regulatory arbitrage should be avoided, which could, for example, arise if residential mortgages denominated in a foreign currency are treated differently from a loan with a corresponding foreign currency swap. The regulatory proposal currently on the table is thus not, in our view, suitable as a solution to the problem portrayed.

Section 3 “Removal of national options and discretions”

Question 16*: Is this suggested scope of maximum harmonisation in 2006/48/EC and 2006/49/EC appropriate?*

If maximum harmonisation is the objective, first of all the reasons for the respective “gold plating” provisions must be examined in each case. If these are superfluous, then we have no objections to a maximum harmonisation.

Question 17*: Is the suggested prudential treatment for both residential and commercial real estate sufficiently sound?*

<u>Exposures secured by real estate collateral [e.g. Directive 2006/48/EC, proposals 17(p) and (q), 22(a), 24(e)]</u>

From our perspective, exposures collateralised by real estate represent a good example case of national discretions which are justified by specific factors of markets in the respective Member States. The CRD recognises the heterogeneity of real estate markets within the EU by linking the possibility to grant certain alleviations regarding the eligibility of real estate as collateral to the existence of a well-developed and long-established real estate market with sufficiently low loss rates stemming from loans collateralised by real estate property. In this regard and with respect to commercial real estate mortgages, the fulfilment of the so called “hard test” criterion is required, which is based on a specified algorithm for deciding whether losses are sufficiently low for a certain market. The German supervisor and regulation institutions consider this CRD requirement as risk adequate and are therefore generally in favour of maintaining the current treatment.

Even more than the commercial real estate market, the residential real estate market is of considerable public importance in the respective Member States. Therefore, residential real estate markets should not become subject to an algorithmically “hard wired” criterion, as proposed by the Commission Services, but should remain subject to individual assessment. We would point out that this is already acknowledged in one case, namely for the Finnish housing market.

There are basic concerns against the proposed reduction of the recognised part of commercial real estate collateral values and with the corresponding specification of explicit LTV-thresholds for residential real estate property. This is neither necessary for reducing options and national discretions nor have the Commission Services provided any empirical evidence that would justify such tightening.

<u>Maturity for exposures to building societies [Directive 2006/48/EC, proposal 20(e)]</u>

We strongly oppose the deletion of this ND (total assets up to EUR 1000 million instead of EUR 500 million) from 2012 on. This is an important rule in particular for building societies, which typically have the business and risk profile of an SME but which, due to the high value of the real estate property under their administration, have high total assets.

Question 18*: Is the suggested timeline (2012) for a single definition of default (i.e. 90 days) appropriate?*

Yes.

<u>Section 4: Simplification of the Bank Branch Accounts Directive</u>

Question 19: *Do you agree that the Bank Branch accounts Directive 89/117/EEC should be amended so that Member States can no longer require the publication of additional information by branches of credit institutions established in other Member States?*

Yes.