STELLUNGNAHME

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Deutscher Industrie- und Handelskammertag

DIHK Comments on the Consultation Document „Revisions to the Standardised Approach for credit risk“

The Association of German Chambers of Commerce and Industry (Deutscher Industrie- und Handelskammertag e.V. - DIHK) is the umbrella organization of the 80 German Chambers of Commerce and Industry and represents the collective interest of commercial and industrial businesses in Germany. Our legitimation rests on more than 3.6 million member companies from all sectors, regions and size classes that belong to the Chambers of Commerce and Industry.

General remarks

We welcome the opportunity to comment on the proposed revisions to the Standardised Approach, since any change in regulatory capital requirements can have important consequences for companies' access to finance. Given that a majority of small and medium enterprises (SMEs) in Germany are serviced by banks using the Standardised Approach, we would like to draw the Committee's attention in particular to the cumulative effects of the proposed changes on SMEs, as a substantial deterioration of financing conditions could be the consequence.

We agree with the Committee's objective to keep overall capital requirements under the Standardised Approach constant, as risk weights are not a systemically appropriate instrument to change the overall capital ratio of the banking system. However, in their current form, the proposed revisions do not seem to fulfill this objective. On the contrary, with a minor exception for some loans secured by residential mortgages, increases in risk weights are considered across all possible asset categories.

Moreover, this increase in risk weights across the board does not seem necessary. It has not been demonstrated that risk weights for traditional banking business have been substantially too low under the current Standardised Approach. In this context, the consultative document refers several times to the need to align the Standardised Approach more closely with the IRBA foundation approach. However, results from the advanced IRBA approach, which are determined statistically and regularly validated, often show that the IRBA foundation approach overestimates risk in many portfolios. Thus, rather than increasing Standardised Approach risk weights to meet IRBA foundation values, a revision of some of the aspects of the IRBA framework might be more

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appropriate. It would also be highly beneficial if the Committee could disclose its empirical analyses underlying the individual calibrations.

The Retail Definition

The consultative document proposes several changes to the delimitation of the retail segment that could negatively impact small and medium enterprises, which often use loan financing from their banks under a highly standardized loan application process very similar to that for private retail clients.

Under the new definition, only loans to ‘small businesses’ could qualify for the preferential treatment of retail loans. The precise meaning of the term ‘small business’ remains unclear in this context. However, in the European Union, there are long-standing definitions for both small and medium enterprises (with a small enterprise having less than 50 employees, 10 million euro revenue and 10 million euro total assets and a medium enterprise having less than 250 employees, 50 million euro revenue and 43 million euro total assets). Under this definition, a restriction to small enterprises would certainly be excessive, since loans to medium enterprises are often originated in the same process as loans to small companies and profit from similar diversification effects. Hence, we strongly urge the Committee to use the term ‘small and medium businesses’ to avoid unreasonable interpretations of the new framework.

According to the consultation document, national supervisors would retain the possibility to define alternative national criteria to the default quantitative granularity criterion. We believe that this flexibility is essential and therefore strongly support this decision. The role of small regional banks (as well as the applicability of the Basel framework to these banks) varies strongly between jurisdictions, and a simple quantitative granularity criterion would strongly restrict use of the retail category e.g. for many regional German banks deeply involved in SME lending. Moreover, depending on the national banking system, an individual bank’s portfolio granularity may also not be the best criterion from a supervisory perspective. In Germany, e.g., the institutional protection schemes that cover the large majority of regional banks actually lead to a risk-sharing in the case of an emergency and thus justify a more integrative view of the joint portfolio held by the schemes’ participants. For this reason, we would even recommend to change the formulation so that an alternative national granularity criterion is considered a full-fledged alternative to the basic granularity threshold rather than an exceptional case.

Moreover, in order to keep loan application processes manageable, the retail segment should be allowed to include a certain percentage of loans to clients classified as corporates, as long as they were decided in the regular retail process and respect the maximum loan amount of one million euro per client. Loans below this volume often do not justify the separate and much more burdensome treatment of larger corporate loans.

We are skeptical about the possibility to differentiate by products inside the retail segment, since an internationally comparable product definition would risk to be both extremely complex and to require frequent revisions.

The Treatment of Corporates

The consultation document proposes to base the risk weight of corporate exposures according to a matrix based on a company's leverage and revenue. Together with the proposed calibration, this would lead to a general increase in capital requirements for the corporate sector and a disproportionate increase for exposures to small and medium enterprises outside the retail segment. Because higher capital costs ultimately translate into higher loan costs, **this would have a substantial adverse impact on company financing and in particular on SME access to finance**.

In particular, the proposed use of absolute revenue as one of the two determinants of risk weights discriminates against smaller companies. This disproportionate burden on SMEs is not justified by prudential concerns. First, while credit risks for individual SMEs are, on average, higher than those for larger companies, exposures to SMEs are also on average individually smaller and less correlated. Thus, a portfolio of SME exposures benefits from a diversification effect that is not adequately taken into account in the present proposal.

Second, larger companies are not safer by virtue of their size, but merely because larger companies, on average, have better values in genuine risk determinants such as the equity ratio. **Thus, while size is correlated with credit risk, it does not cause it**. Basing the prudential framework on a spurious correlation of this kind introduces omitted variable bias and causes serious steering mistakes: SMEs with better than average values in genuine risk drivers are unjustly classified as risky, whereas those larger companies with problems would equally unjustly profit from a generalized 'size bonus'.

Moreover, calibrating requirements for SMEs based exclusively on data from banks using the IRBA can lead to unreasonable results. In Germany, the majority of SME loans is handed out by banks using the Standardised Approach, and there is no reason to believe that the subset of SMEs serviced by banks using IRBA is representative of the broader universe of SMEs. Hence, such

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tenuous data does not justify an across-the-board increase in capital requirements for these companies. Finally, regulatory capital is meant to protect against unexpected losses, while the banks' pricing decision covers expected losses. A higher rate of expected losses for SMEs, however, does not necessarily imply that unexpected losses are also higher for this category.

The second risk determinant proposed in the consultation document, a company's leverage ratio, seems a more reasonable candidate for inclusion into the framework since a company's equity position has a direct causal impact on its probability of default. However, there are also difficulties associated with this measure. In different sectors of the economy, different leverage ratios are reasonable, and a comparison of leverage across, e.g., trading companies and industrial companies is not likely to adequately capture the associated risk. Thus, some form of sectoral clustering would seem necessary in this respect. Moreover, leverage ratios are fundamentally affected by national accounting rules and thus difficult to compare internationally. Hence, any such use would necessitate opening clauses for adjustment at the national level. Furthermore, companies and more generally industries at different points during a product lifecycle tend to have different leverage ratios, which implies that the new framework could put particular burdens on loans to innovative industries and start-up companies.

More generally, the matrix proposed by the consultation document would also lead to an increasing instability of capital requirements on the individual level, and an increasing pro-cyclicality on the macro-economic level. In many sectors, turnover figures experience substantial variation over the business cycle. Moreover, investments usually lead to an increase in leverage first and an increase in revenue later, i.e. they would first increase and then decrease a company's risk weight over time. Instability in capital requirements hinders the necessary capital planning for banks and risks creating more severe and lasting downturns during the more difficult times of the business cycle.

Use of the risk driver matrix is partly motivated by the Committee's principle to remove references to external ratings. We agree that ratings cannot replace each banks' credit analysis, but consider the complete ban of rating references to be excessive. Even during the crisis, only ratings for asset-backed securities, but not those for corporates, showed serious shortcomings, and substantial improvements in rating agency regulation since the crisis have increased the sector's reliability further. Hence, in our view, ratings can still often be a useful and more precise measure of risk than broad-scale generalizations based on a few variables.

Against the background of these serious difficulties, we would recommend to consider maintaining the current system of rating-based risk weights for rated corporates and a flat risk weight for other corporates. Alternatively, a flat risk weight could be used for small and medium enterprises and a

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risk weight based on a risk drivers table for larger corporates. If the Committee cannot agree to either approach, we would consider a substantial reduction in the new risk weights, a replacement of revenue with an indicator not discriminating against SMEs and a clustering of reference values for risk drivers by economic sector as the minimum adaptations necessary to prevent a negative impact on SMEs and the wider economy. In any case, risk weights for SME exposures should sufficiently reflect the diversification benefits obtained for a portfolio of such loans.

Credit Conversion Factors

The consultation document also foresees a general credit conversion factor (CCF) of 10% for unused credit lines which can be cancelled at any time by the bank, as opposed to the current 0%. Such a capital requirement would create a disincentive for banks to provide credit lines and hence reduce the flexibility needed by many companies, with substantial adverse consequences for company financial planning. Moreover, it seems unjustified from a prudential perspective. The consultation document argues that consumer protection laws and reputational risks hinder a bank's effective ability to cancel credit lines. Reducing available credit to a debtor with a worsening credit-worthiness is normal banking business and does not carry serious reputational risks as long as the decision is based on reasonable risk management procedures. When dealing with business customers, it is even completely accepted and understood by all sides of the market. The document also points to customer protection regulations as a possible source of non-revocability. However, these vary widely between jurisdiction and are, in any case, not applicable to businesses. For these reasons, we strongly support keeping the 0% credit conversion factor for credit lines cancellable at any time. At a minimum, a higher CCF should by applied on credit lines for consumers only, and exclude those credit lines offered to businesses.

Treatment of Banks

The consultation document proposes to differentiate risk weights for banks based on core tier 1 equity ratios and non-performing loan ratios. We understand the Committee's dissatisfaction with the current approach to determine risk weights for bank exposures. However, the new proposal has some difficulties of its own and has important interdependencies with the treatment of sovereigns.

The present proposal reserves a reconsideration of risk weights for sovereign exposures for a separate future project. However, there is a substantial interdependency between both categories because excess liquidity is generally held either at other banks or in sovereign bonds. **Increasing risk weights for one category but not the other would further increase the already privileged position of sovereign bonds in the framework and risk creating unwanted incentives to**

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increase sovereign exposure. We would therefore recommend to the Committee to consider postponing the changes to the treatment of bank exposures and to include them in the future review project for sovereign exposures.

Furthermore, the complete ban of references to external ratings seems overdrawn also in this context. In addition, collecting information on CET1 and NPL ratios for many counterparties could be a substantial burden, so that a de minimis exception for small exposures with a generalized risk weight would seem advisable, as would a reduction of capital requirements for short-term exposures. Moreover, an exposure’s remaining time to maturity should be considered as a further risk determinant.

Moreover, defining the notion of ‘bank’ directly inside the Basel rules creates the risk of a definition that is too narrow to accompany certain national specificities. For the German case, we would in particular recommend a clarification that financial leasing companies continue to be classified as banks. These companies are an important vehicle to finance investments in the German economy, and any increase in their refinancing costs would have negative effects on the financing of investments.

Finally, we would like to draw the Committee’s attention to possible adverse effects of its proposal on public policies to support particular sectors of the economy (such as start-ups, SMEs or specific forms of housing construction). In Germany, both the federal government and state governments use promotional banks to hand out promotional loans to beneficiaries of such policies via the beneficiaries’ own banks as intermediary. This structure has proven very successful and efficient. However, as a result, publicly owned promotional banks have a high amount of claims against the banks serving as intermediaries and would be particularly affected by an unreasonable increase in capital requirements for bank claims.

Treatment of Real Estate and Specialised Lending

The consultative document proposes two alternatives to treat loans secured by commercial real estate. In the first option, such loans would generally be considered unsecured but could be given more favorable treatment nationally under strict conditions. In the second option, a risk weight between 75% and 120% would be applied according to the loan-to-value ratio.

In order to protect the availability of funding for commercial real estate while respecting the need for prudent behavior on the part of banks, we believe that a combination of both approaches would yield the best results. The established hard test criterion as used in the European Union regularly verifies the maturity and stability of the real estate market. Where the hard test is met, a risk weight of 50% for loans secured by commercial real estate should remain applicable. Where the hard test is not met, however, the proposed table from option B could be a reasonable basis for a differentiation of risk weights according to the loan-to-value ratio.

The criteria used for loans secured by residential real estate are less directly relevant for company financing. Nevertheless, it seems unclear why the consultative document rejects the established practice of splitting an exposure into a secured part (e.g. up to a specified percentage of the LTV) and an unsecured part. We would support maintaining this possibility. A 35% risk weight should be possible at a minimum in those cases where the hard test criteria are met.

Finally, the new risk weights of 120% and 150% for the specialised lending categories seem both too high and too undifferentiated. The risk weights should reflect both the credit-worthiness of the debtor and the actual degree of risk of the respective project (which may vary substantially, e.g. by the point in time where units are sold in a building project). The Committee should consider not to classify some real estate project financing in the specialized lending category if specific conditions (such as a hard test) are met in the relevant market. In this context, we would also like to note that the Committee's assumption that specialized lending constitutes only a small part of the activity for banks using the Standardised Approach does not always hold. In fact, specialised lending often requires strong localized knowledge, which is a niche successfully occupied by some smaller banks in Germany.

Concluding remarks

As we have outlined in this paper, we believe that substantial adjustments to the consultative document are necessary in order to successfully combine the requirements of prudential supervision and the economy's need for a working financial ecosystem.

This is true even more so since the revised Standardised Approach will likely serve as a floor for banks using the IRB approach as well. Moreover, in the European Union, the Basel requirements are traditionally extended to all banks even though they are technically aimed only at internationally active banks.

In this context, we would strongly support the inclusion of an express clarification by the Basel Committee that any national deviation from the rules only for those banks not originally covered by the scope of the Basel framework will not later be considered non-compliance with the framework.[1]

[1] A model would be the respective statement in BCBS 283, number 11.

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This would greatly contribute to clarity in later national implementation debates and sharpen the division of responsibilities between the Committee concerned with internationally active banks and national supervisors concerned with their respective financial systems.

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