German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

On the EBA Consultation Paper "On the definition of materiality thresholds for specific risk in the trading book under Article 77 of Directive 2013/36/EU (Capital Requirements Directive - CRD IV)" (EBA/CP/2013/33)

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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-sector 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 more than 2,000 banks.

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Comments "On the definition of materiality thresholds for specific risk in the trading book under Article 77 of Directive 2013/36/EU (Capital Requirements Directive - CRD IV)" (EBA/CP/2013/33)

On 30 July 2013, the European Banking Authority (EBA) published its Consultation Paper "On the definition of materiality thresholds for specific risk in the trading book under Article 77 of Directive 2013/36/EU (Capital Requirements Directive - CRD IV)". We welcome the opportunity to comment on this Consultation Paper.

I. General Comments

When drafting the technical standard, we suggest taking into account that there already are active consultations underway regarding a *Fundamental Review of the Trading Book*. For this reason, it would be very onerous and costly if a potential model implementation was initiated on the basis of the technical standard only to be abrogated again in the near future.

We are of the opinion that the decision as to if an internal model shall not only be used for the purposes of internal governance but also for the purposes of determining supervisory capital adequacy requirements should remain part of business policy decisions. This paradigm is part and parcel of current supervisory practices; it shall and may not be abrogated by means of a technical standard. Under its current proposals, the EBA lays down threshold levels. However, any mechanistic rule where exceeding these thresholds automatically lead to a need for banks to declare an internal model for the purposes of Pillar I would have to be considered as an undue interference with banks' entrepreneurial freedom. In our view, this is not covered by the mandate under Article 77 CRD IV. Hence, in order to avoid misunderstandings, we suggest clarifying this in the EBA standard and / or in its recitals.

Under Section 5.1.2 of the present Consultation Paper, the EBA points out that its current proposal was motivated by "the overreliance on external ratings giving rise to pro-cyclicality and 'cliff' effects". However, when it comes to trading book positions, more likely than not, this will concern first and foremost securitisations; "simple" debt and credit derivatives eligible for treatment by an internal model for interest rate risk will be affected hardly ever. Besides, even internal models that are being used for the purposes of calculating the interest rate risk in the trading book frequently solely draw upon external ratings: Even when calculating the incremental risk charge (IRC), it is neither a binding standard nor a common market practice to use internal ratings. Hence, the proposed requirements fail to deliver the EBA's / the European Commission's declared goal. Based on the foregoing, we hold the view that banks should not be forced into adopting an internal model for the purposes of calculating the specific risk as well as (c.f. below) the general interest rate risk.

Furthermore, in order to avoid misunderstandings, we suggest clarifying in the recitals that the respective supervisor may act with "reasonable discretion".

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During the internal model implementation, the usual approach is as follows: The bank begins with the partial use for general interest rate risks and subsequently incrementally incorporates the other risk categories. Compliance with the requirements for a specific market risks model which are being defined under Article 370 CRR (*inter alia* P&L explain, back-testing aimed at assessing whether specific risk is being accurately captured) is only possible by modelling the general interest rate risk as well. Hence, the bank is automatically also forced into implementing a model for the entire interest rate risk (general and specific interest rate risk). We propose taking this circumstance into account during the forthcoming definition of thresholds.

II. Specific Comments

Q1. Do you agree with the use of an absolute materiality threshold?

In our preliminary understanding, the thresholds shall be understood rather as guidance and not as mandatory criteria. As an alternative regulatory choice, we advocate in favour of a solution where the respective banks are entitled to return their supervisory model approval (opt-out clause). With their existing resources, many banks would be incapable of meeting the stringent supervisory requirements with regard to modelling of default and migration risks as well as the requirements with regard to a model's operation (back-testing, validation, parallel calculation for model change policy etc.).

Furthermore, we have difficulties in comprehending the rationale for defining an absolute threshold that is based on the nominal value of positions. In our view, there are two major shortcomings with regard to the proposed threshold:

1. A definition should be chosen which seeks to assess in how far "trade" is *de facto* taking place in the specific risks (long – vs. short positions). Only in the presence of, for instance, a significant trading activity of CDS against bond positions is there a need in the first case for a risk model treating the specific interest rate risk. *In extremis*, the proposed threshold definition causes a bank holding a debt security position in its trading book of slightly over EUR1 billion spread across one or a limited number of AAA government debtors would be forced into introducing an internal model for the specific interest rate risk. Contrary to this, a bank with frequently changing positions of slightly below EUR1 billion could continue to use the standard model for this.

2. Furthermore, we have grave concerns over the threshold's lack of risk sensitivity. For instance, an instrument featuring an identical nominal value and a residual maturity of 3 months will feature far less specific risks than an instrument with a residual term to maturity of 10 years. In this regard, we are of the opinion that it would be more constructive if the determination of the significance of the specific risk was predicated on a risk sensitive ratio (e.g. credit spread sensitivity instead of nominal value). When there is uncertainty in this regard, the most risk sensitive ratio should also be set in relation to the bank's size orits own funds; after all, depending on their size / capitalisation, one and the same exposure can take on different impacts within banks.

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Hence, if a "simple" threshold on a nominal basis shall remain applicable, we advocate strongly in favour of at least doubling the envisaged nominal value threshold.

Q2. Do you agree with the proposed values for: (i) overall specific risk and (ii) significant number of (iii) material exposures? If you believe the values are inappropriate, please provide some rationale and alternative values.

Under Article 77 of the CRD IV, the conditions are tied to the absolute position and the presence of a large number of material counterparties. These two conditions are linked by the word "and" meaning that the scenario will only be subsumed under the regulatory scope if both conditions are met. Yet, in its Consultation Paper the EBA ignores this and proposes an "or" link (cf. Section 3, page 7 "Joint consideration of both criteria"). Hence, under the proposals of the Consultation Paper, the regulatory requirement will already be triggered if only one of the two requirements is met. In our view, this extension of the regulatory scope is not covered by the EBA's legal mandate.

Yours faithfully,

For the German Banking Industry Committee

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