German Banking Industry Committee

Die Deutsche
Kreditwirtschaft

Comments

on the EBA Consultation Paper
Draft Guidelines on specification of types of exposures to be associated with high risk under Article 128(3) of Regulation (EU) No 575/2013 (EBA/CP/2018/03)

Register of Interest Representatives
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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 1,700 banks.

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The European Banking Authority (EBA) issued its Draft Guidelines on specification of types of exposures to be associated with high risk under Article 128(3) of Regulation (EU) No 575/2013 for consultation on 17 April 2018. We appreciate the opportunity to submit our comments.

1. General comments

We wish to start by noting that we do not believe that publication of these draft guidelines is necessary. On the one hand, the mandate to develop guidelines dates back to 2013, i.e. it is almost five years old. This shows that the supervisors, too, evidently do not assign this topic a high priority. On the other, the "high risk" requirements are likely to be superseded in the foreseeable future when the finalisation of Basel III (Basel IV) is implemented. Additionally, Article 128 of the CRR is also expected to be amended as part of the current revision of the CRR. The short-term implementation of the new requirements in this regard will thus lead to avoidable regulatory costs without any evident long-term benefits. Moreover, we take the view that the published draft guidelines create little clarity for practical application.

Notwithstanding the above, we wish to comment on certain points in the guidelines.

2. Specific comments

Question 1: Do you agree with the proposed clarifications in paragraphs 2 and 3? Would you like to bring forward arguments which potentially mitigate the caveats of the alternative approach for defining what constitutes an investment in private equity?

Strategic investments are correctly excluded from the definition of private equity exposures.

In addition, we wish to suggest that equity exposures resulting from the restructuring of loan exposures (foreclosed assets) should also be excluded from the analysis of high risk exposures. The initial objective of these investments is to avoid further losses. In the case of a wider interpretation, this also falls under the intention of generating a profit in accordance with EBA GL 4.1.3, which could imply classification as high risk exposures. However, we do not believe that they exhibit the classic features of an investment in private equity. One of the reasons for this is that the transfer prices for transferring the assets/shares in the bank's balance sheet are normally significantly lower than the loan amounts at which the assets/companies were previously financed. Any necessary impairment losses were already charged to a large extent on the previously existing debt finance. Moreover, the corresponding investments are equity-financed to a particularly strong extent compared with classic investments in private equity. In contrast to classic investments in private equity, high costs of debt due to excessive leverage are therefore not expected and reduce the probability of default. Compared with investments in private equity, foreclosed assets are not subject to any fixed deadline requirements for resales, nor are there any requirements for generating a minimum return. In light of this, we do not see any need to classify the exposures as high risk. This should be clarified by the EBA Guidelines.

Question 2: Do you agree that the identification of high risk items is particularly relevant for some of the existing exposure classes?

The explanations in the Explanatory box on page 14 appear to be contradictory. One the one hand, they state that all types of exposure classes must be considered when identifying "items associated with particularly high risk". On the other, they expect that corresponding high risk exposures are expected in par-

ticular in the "Corporates", "Equity" and "Other items" exposure classes. We assume that it is not necessary to identify high risk exposures across all exposure classes and hence in all of an institution's customer segments. The related expense would be unjustifiable.

The EBA states that the applicable risk weights for the corporates, retail, and equity exposure classes are calibrated as averages, but that there are certainly exposures with higher and lower risks in the exposure classes. To the extent that the "high risk" exposure class isolates certain exposures and assigns them a higher weighting, we take the view that the credit risk in the remaining exposure classes will be lower and the weighting should be correspondingly reduced.

As a general principle, we believe that the rating of high risk exposures for equity investments is already covered by the specific list of exposures in Article 128(2) of the CRR. In our opinion, additional requirements for the equity exposure class go beyond the EBA's current mandate.

We also wish to draw attention to current developments at the international level: the BCBS's guidance on the finalisation of Basel III indicates that in future, only the standardised approach will be permitted in future for equity investments. In the wake of this, the standardised risk weight would be increased from currently 100% to at least 150% for most of the exposures in this asset class. The analysis of high risk items in the equity exposure class will therefore no longer be necessary. This is just another argument for not releasing the Guideline.

In practice, the requirement in point 4.2.7 of the EBA GL for an assessment of all exposures to establish whether there are possible additional exposures to the counterparty will lead to a high implementation effort. In addition to the existing risk weight for the exposure, hypothetical exposures outside the equity exposure class would have to be generated and corresponding risk weights would have to be calculated. An in-depth analysis of each loan in this exposure class to establish high risk would unreasonably burden small institutions in particular. The SA already stipulates higher own funds requirements than advanced approaches. This should not be undermined by introducing additional analysis requirements in this approach.

In light of the Basel requirements referred to above, the resulting no more than temporary relevance of the requirements of the EBA Guidelines for equity exposures and the high analysis requirements, we wish to argue in favour of deleting point 4.2.7 of the EBA GL.

For the analysis process, the introduction of a *de minimis* rule could serve as an alternative. This could either refer to certain exposure classes (such as retail) or a quantitative limit.

Question 3: Do you have any comments or concerns regarding the proposed scope of the exposures at least to be analysed according to paragraph 5? Should more guidance be provided as regards other types of exposures? If yes, please provide specifications.

In our view, basing allocation to exposure classes on LGD is problematic and unsystematic because this is only a single parameter used to measure credit risk. As a general principle, credit risk is measured by reference to the expected loss (EL) and the unexpected loss (UL). This principle is recognised by the supervisors in the implementation of the IRB Approach, but ignored at this point in the SA. By focusing exposure class allocation for high risk exposures primarily on LGD, exposures with an absolute or relatively low EL or UL may incorrectly be allocated to the special "high risk" class.

In general, the question of the point from which a risk exposure has a high risk of loss remains unanswered. In this context, institutions with a different risk profile could arrive at different assessments of

whether a risk exposure is associated with a high risk or not. From our perspective, this would have to be specified in further detail in order to minimise room for interpretation in the banking sector.

The analysis of "project finance" contains the sort of criteria that are used in the IRB Approach for granular project finance, though Level 2 acts on the IRB Approach do not need to be considered. However, it should be ensured that the boundaries between the SA and the IRB are not further blurred and criteria are added that make the intensity of analysis stronger compared with the IRB, without benefiting from the capital relief that is normally associated with it.

It is also unclear how speculative immovable property financing in Article 128(2)(d) of the CRR would be distinguished from the two other high risk exposures proposed in paragraph 5b) of the EBA GL. This could lead to greater legal uncertainty than clarity, which is likely to run counter to the fundamental objective of guidelines.

Moreover, we wish again to draw attention to current developments on the finalisation of the Basel III requirements: the proposed new (sub-)exposure classes of "specialised lending exposures" (for property, object and commodities finance) and "land acquisition, development and construction exposures (ADC)" have strong similarities to the criteria proposed in paragraph 5 of the EBA GL. This is likely to lead to categorisation difficulties. Additionally, a basic weight of 150% is proposed, with the result that the analysis to establish high risk factors in this exposure class is also likely to be superfluous.

The four criteria for classifying specialised lending exposures as high risk listed in paragraph 5(b)(i) should be assessed in the aggregate and should therefore be worded as a cumulative requirement (AND operation).

Question 4: Do you agree to the proposed scope of exposures to be assessed in Paragraph 6 (a) in order to identify additional types of exposures which should be subject to a potential assignment to the high risk exposure class due to being structurally different?

n/a

Question 5: Should there be a notification mechanism as proposed in paragraph 6 (b)? Based on the current portfolio of exposures, would you expect that your institution (the institutions represented by you) would need to provide a notification?

In order to meet the requirements in paragraph 6(b) relating to identification as high risk and notification to the EBA, the necessary information as to whether classification as high risk was made under paragraphs 5 or 6(a) would have to be available. This would require existing processes to be adapted or expanded, which would be associated with considerable effort (identification of such exposures, systematic capture, expansion of interfaces, etc.). Additionally, it would be necessary to implement a new process in order to notify the EBA about the existence of such exposures. In our view, the requirements of paragraph 6(b) are therefore not practicable. Because, moreover, no supervisory added value will be created by meeting these requirements, paragraph 6(b) should be deleted without replacement. In our opinion, this would also be in line with the European Commission's Fitness Check on Supervisory Reporting, which aims to simplify reporting obligations.