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Comments of the Zentraler Kreditausschuss on the working document of the European Commission services concerning potential changes to the CRD under the co-decision and comitology procedures

13 June 2008

I. General remarks by the ZKA on the Commission's proposals

Before commenting on the content of the discussion paper we would like to make a few general observations.

1. The discussion paper is not a formal proposal by the European Commission for a review of the CRD. Nevertheless, we assume that the proposed potential changes largely reflect the planned scope of the Commission proposal. Should the formal proposal, which we understand will be presented to the Parliament and the Council in October 2008, include additional content, these areas will also have to be opened to adequate consultation with affected parties. Otherwise, the standards of better regulation would be seriously compromised.

2. The importance of adhering to better regulation principles is shown by the results of preliminary work on the paper. The banking industry was involved in preparations at an early stage and invited to comment. We warmly welcome this. Those proposals which were the subject of extensive consultation have turned out to be largely appropriate and practicable in our opinion. Proposed changes on which there was no adequate consultation, by contrast, are often unfeasible or run the risk of damaging the market.

3. It is important to bear in mind the current discussions by the Basel Committee on Banking Supervision (BCBS) on adjusting certain aspects of the Basel framework. These discussions are taking place in parallel to the review of the CRD. In areas where it is already apparent that there will be changes to the Basel rules, the Commission should refrain from amending the directives. Any amendments should only be carried out after the BCBS has submitted its conclusions. There is otherwise a danger of discrepancies between the EU and Basel regimes.

   At best, the CRD would then have to be readjusted and ongoing or completed implementation work by the banks would have to be abandoned and begun again. This would result in considerable sunk costs for all concerned. At worst, the upshot would be permanent or at least temporary divergence between European and international rules. This would give rise to severe competitive distortions and risk placing European banks at a disadvantage compared to their US counterparts, in particular.

   The latter point applies above all to securitisations, which are also being examined by the BCBS. We believe it would be especially unfortunate to make premature changes to

the existing Basel II regime in an area so highly sensitive to competition. The financial turmoil of recent months was caused by transactions entered into under Basel I. It remains to be seen how the new Basel II capital requirements will perform in practice. Carrying out changes at this stage could undermine a functioning system which sets appropriate incentives and thus jeopardise stability.

4. CEBS has recently provided the Commission with extensive advice on the possible future development of certain legal aspects. The banking industry was closely involved in the various areas covered. Now that CEBS's recommendations have been submitted to the Commission and incorporated into the discussion paper, we consider the work of the committee concluded in this field.

   We warmly welcome the Commission's shift in many areas towards principles-based regulation. These rules leave enough scope for the national interpretation needed to ensure a level playing field, which has to be based on existing, widely diverging laws and where appropriate, case-by-case interpretation is required in supervisory practice. Once the directive is finally adopted, it will need to be interpreted across Europe in a consistent manner. This is the responsibility of CEBS in its capacity as a Level 3 committee. In the opinion of the ZKA, however, this is a fresh task and should not simply duplicate the findings reached by CEBS in the course of its preliminary work. It is the new directives which must form the starting point.

The German banking industry has particular concerns about the following proposed changes to the CRD and would like to briefly highlight them ahead of our detailed comments.

Large exposures

In their present form, the proposed rules on large exposure limits for interbank exposures are unacceptable in our view. Besides generally questioning the prudential motives for these rules, we wish to point out that the resulting considerable restrictions on banks' liquidity management would negate any potential prudential effects. They would also impose a competitive handicap on European banks compared with their US peers. Moreover, fully counting interbank exposures towards the large exposure limits would call into question the public development mandate given to German development banks. We therefore call for a critical examination of the arguments and proposals discussed to date. For these reasons, we are in favour of preserving the status quo. To ensure the functioning of the money market and thus the provision of liquidity to banks, the exemption of interbank exposures in the 0-1 year time band should definitely be retained. Because of the systematic competitive handicap for

smaller banks and as these do not generate any systemic risk, establishment of a volume-based threshold for interbank exposures regardless of their maturity – as already provided for under the current proposal – would be appropriate.

Also, we take a critical view of the proposals for amendment of the definition of "*group of connected clients*". We are against the idea to take funding aspects into account when defining groups of connected clients. In our view, the large exposures regime is not the right instrument to address these risks properly. As we believe that the present wording of the directive duly fulfils its regulatory purpose, no CEBS guidance on interpretation of Article 4(45) is necessary in our opinion.

The proposed mandatory "look-through" approach to identify groups of connected clients not only causes considerable technical problems at all banks, but is also seriously detrimental to banks organised in networks. The latter would be forced to reduce their network holdings significantly, though there is no need for this from a risk perspective. We are therefore strongly in favour of the introduction of the optional look-through approach already proposed by CEBS.

Supervisory arrangements

Given the extent to which the economic importance of foreign branches has grown, the German banking industry recognises the need, reflected in Article 42(3), to give more extensive information rights to competent authorities in countries where systemically relevant branches are located and involve them more closely in times of crisis. We would nevertheless like to point out that this change represents a partial erosion of the home country principle and a restriction on the use of the EU passport. The extension of the powers of host competent authorities should therefore be strictly confined to the areas mentioned and should not otherwise affect the division of responsibilities between the various competent authorities.

The German banks welcome the creation of colleges of supervisors. In the interests of a level playing field, however, it is important for all colleges to operate by the same standards. The current call for CEBS simply to prepare "guidelines for the operational functioning of colleges" does not go far enough in our view. The directive should also require CEBS to monitor whether the various colleges comply with the above guidelines in practice and apply them in a consistent manner. In addition, steps must be taken to ensure that the colleges function efficiently and thus that their composition is determined on a case-by-case basis.

We see a need to spell out in more detail how the consolidating supervisor is to plan and coordinate supervisory activities (Article 129(1)(b)). We therefore advocate giving the

consolidating supervisor clear powers vis-à-vis other competent authorities to determine planning and coordinating procedures (internal relations between competent authorities). This would not affect supervisors' relations with supervised entities (external relations).

Securitisations

To avoid competitive distortions at international level, we advocate aligning any necessary changes to the CRD with adjustments carried out by the Basel Committee. The BCBS has announced that it will issue proposals before the end of 2008 on modifying risk weights for certain complex structured credit products such as CDOs of ABS and on enhancing capital charges for liquidity facilities to ABCP conduits.

We argue strongly against the proposed change to Article 95. There is no equivalent of this planned rule at Basel level. Introducing a minimum capital charge for originators irrespective of the volume of retained securitisation positions would place European banks at a considerable disadvantage compared to their international competitors. What is more, setting aside capital for risks transferred in full has no justification from an economic or risk perspective and takes no account of the fact that residual risk is at least partially already covered by the definition of operational risk and subject to capital requirements under Basel II. Such a rule would not set an additional incentive for sound lending practices but encourage regulatory arbitrage. It would also lead to a systematic divergence of economic and regulatory capital requirements, thus undermining one of Basel II's key objectives. In our view, any negative incentives in the originate-to-distribute model should be counteracted by qualitative requirements under Pillar 2 aimed at ensuring appropriate lending practices among both originators and investors.

II. Comments of the ZKA on the Commission's individual proposals

The ZKA believes that the changes proposed by the Commission to the Banking Directive and the Capital Adequacy Directive are, overall, a good compromise. Where it does not comment specifically on the Commission's proposals in the following, the German banking community explicitly endorses these.

The articles and annexes referred to in the following relate to the Banking Directive (2006/48/EC). Where reference is made to other texts, e.g. the Capital Adequacy Directive (2006/49/EC), the text in question is explicitly named.

A) Large exposures

Article 4, paragraph 45

We assume that the proposed wording is designed to prevent future cases of risk concentration in which reliance on a single source of funding leads to a liquidity squeeze on the part of the debtor in emergency situations and may thus land the funding bank in trouble as well (see example of IKB Bank). We support the intention to avert such potential risk concentrations by setting regulatory rules. At the same time, we regard the form chosen for doing so as inappropriate. The large exposures regime is designed to control single-name risk. Risks arising from the funding of clients can scarcely be separated from sectoral or regional risk, however. Depending on the composition of a portfolio, there may, for example, be industry-related or geographical concentration risk. This must be addressed solely under Pillar 2. The problem should therefore be duly addressed prudentially in Annex V.

The proposed wording also inevitably leads to two clients who are funded essentially by one and the same bank being treated as a single unit. Here, too, the bank's collapse would put both clients in a very difficult situation. We assume, however, that the proposals are not intended to set a requirement to treat such clients as a single unit. For this reason, their exact regulatory purpose would have to be defined clearly in the directive.

Finally, we should like to come back in this context to the "group of connected clients" definition at CEBS level. We assume that our arguments on the need for interpretation of mutual "interconnectedness" were convincing, as no proposal for an amendment of the directive that would make unilateral interconnectedness a criterion for treatment of clients as a

single unit has been submitted. Further specification of this criterion at CEBS level is therefore unnecessary in our view.

Article 106, paragraph 3

The proposed mandatory "look-through" approach to identify groups of connected clients in the case of investment units, securitisations, equity exposures, etc. has serious negative implications for the banking sector. Firstly, the recommended rules create considerable technical difficulties at banks. Particularly in the case of both multi-tier indirect equity exposures and investment units, the exact size of each exposure is either not available in the first place or can only be determined with an unreasonable amount of difficulty.

Secondly, the recommended rules create considerable additional problems for banks organised in networks with regard to the individual large exposure limits. Because of the network structure, banks within a network usually have both direct equity exposures to network entities and, in addition, equity exposures to holding companies which, in turn, have equity exposures to these entities. Particularly in the case of smaller banks, which have a low level of equity, aggregating the indirect and direct equity exposures would lead to the individual limits for large exposures to counterparties being exceeded. It should be borne in mind in this context that these are strategic equity exposures which have been held by banks for many years, which serve to strengthen the network concept and which have never caused any problems in the past.

To avoid such negative consequences, we recommend adopting the CEBS proposal, according to which supervisors determine jointly with the bank concerned whether the risk of default results from the possibility of default of the underlying assets or of the fund as such. This proposal has already been implemented for investment units under the current German rules, which stipulate that banks can choose whether the fund as a whole or its individual parts should be counted towards the large exposure limits. We therefore suggest incorporating the present German rules, extended to cover the other items in Article 79(1)(m)(o) and (p), into European law.

Article 110, paragraph 1

Overall, the proposals for a new large exposures reporting regime go much further than the current status quo. Whilst we appreciate in principle the need to report information to competent authorities, a reasonable balance should be struck between the administrative burden this would impose and the potential benefits. A requirement to report exposures

exempted from counting towards the large exposure limits and exposures that do not exceed the large exposure limits after application of credit risk mitigation techniques is of little use in our view, as it would not deliver any additional benefit in terms of the objectives of the large exposure rules. The proposals outlined will, moreover, make costly and time-consuming system modifications necessary. This therefore raises the question of ways to simplify things. For example, we see no need for any differentiation based on credit risk mitigation instruments as called for in Article 110(1)(c).

Article 110, paragraph 3

We believe that the requirement for banks to analyse their exposures to collateral issuers and providers of unfunded credit protection for possible risk concentrations is sensible and justified. This analysis should, however, be confined exclusively to the procedures under Pillar 2. May we point out that under Article 114(3), if banks use the Financial Collateral Comprehensive Method they are required to conduct stress tests which also include analysis of concentrations of credit risk mitigation techniques. We cannot therefore see any significant additional prudential benefit from this rule and consequently suggest that it should be deleted.

Article 111, paragraph 1, points (i) and (ii), in conjunction with deletion of Article 113, paragraph 3, points (i) and (n)

Fully counting interbank exposures towards the large exposure limits would in our view have significant undesirable consequences.

The preferential treatment of interbank exposures was introduced under the large exposures regime to ensure the functioning of the interbank market. Given that the European Commission sees its proposals also as a response to the financial market crisis, it is puzzling that the procurement of liquidity by banks is now to be made more complicated and expensive without any good reason. Dropping the preferential treatment of interbank exposures would be counterproductive in the current – and also in any future – financial and liquidity crises, i.e. it would lead to a further shortage of liquidity and thus trigger or aggravate market disruption. Without a reliable assessment of the impact on the interbank market, there should be no changes to the regulatory framework in this extremely sensitive area.

We anticipate the following negative consequences:

- Significant competitive disadvantages for European banks compared with their international competitors because there is no equivalent rule in other jurisdictions such as, for example, the United States.
- Substantial restrictions on banks' liquidity management, as verification of compliance with the large exposure limits would markedly slow down the speed of response in liquidity management.
- Discrimination of banking systems traditionally based more on money market funding than on capital market funding, as banks are restricted in their choice of counterparties by the possible limitation of liquidity.
- The diversification of counterparties enforced by the rule would also mean that poorer credit quality would have to be addressed.
- Competitive disadvantages for small and medium-sized, regionally operating banks compared with large internationally operating banks.
- Competitive disadvantages for banks whose business model includes large-scale derivatives business, since on application of the mark-to-market method the prudential add-on would have to be largely included in calculation of the large exposure limit. This add-on cannot be covered in the customary market collateralisation of derivative transactions and is only allowed to be partially taken into account in prudentially recognised netting.
- A threat to the existence of the German development bank system. Fully counting interbank exposures towards the large exposure limits generally calls into question the public development mandate given to development banks. The excesses of the large exposure limits, which have to be backed by capital, would in some cases erode the entire own funds. In view of the special features of development bank business, we strongly urge that development banks be exempted from application of the rules on interbank exposures under the large exposures regime.

For the aforementioned reasons, we are in favour of preserving the status quo. To ensure the functioning of the money market and thus the provision of liquidity to banks, the exemption of interbank exposures in the 0-1 year time band should definitely be retained. At most, a moderate increase in weightings could be discussed in the longer-term range on the basis of a reliable impact study. Because of the systematic competitive handicap for smaller banks and as these do not generate any systemic risk, establishment of a volume-based threshold for interbank exposures regardless of their maturity – as already provided for under the current proposal – would be appropriate. If changes to the weighting system for interbank exposures are made, banks must be given a reasonable transitional period to adapt their liquidity

management arrangements. Finally, for competitive reasons the rules should be adopted without any national options.

<u>Deletion of Article 111, paragraph 2 (old)</u>

We expressly welcome the rewording of the rule on the treatment of group entities which are not banks. The abolishment of the special 20% limit for non-banks means that these subsidiaries are at least put on a par with other counterparties. At the same time, we generally believe that the risk of lending to subsidiaries is lower than that to other counterparties, so that this equal treatment must be seen as a marked improvement of the directive.

<u>Deletion of Article 110, paragraph 3 (old)</u>

We see the abolishment of the 800% limit as a welcome simplification of the rules. The discussion held last year on the issue at CEBS level showed that this limit has been insignificant in practice so far. Deletion of this paragraph is therefore justified.

<u>Article 113, paragraph 1, point (e), Article 113, paragraph 3, point (e) (old), in conjunction with deletion of Article 115, paragraph 1 (old)</u>

We are against dropping the preferential treatment of exposures to EU member states' regional governments and local authorities which are assigned a 20% risk weight. The present rule for the recognition of regional authorities takes account of these borrowers' better credit standing. The new proposal in Article 113(1)(e) allows preferential treatment only of entities assigned a 0% risk weight under the Solvency Regulation. In this context, we also recommend that the large exposure rules and the Solvency Regulation be generally synchronised. The different treatment under the large exposures regime and the solvency regime is unjustified in risk terms and – in ECA-covered business, for example – seriously handicaps European banks in competition with their international peers. The Solvency Regulation gives supervisors the option of treating regional authorities like the central government or banks. This option makes allowance for the different constitutional and administrative situation in the EU member states. In line with the risk weights for banks, graduated credit conversion factors should therefore also be introduced for exposures to regional authorities.

The present zero weighting of exposures to central banks and central governments denominated in the national currencies of the borrowers under Article 113(3)(e) (old) should also be retained. The matching-currency funding requirement eliminates the currency risk.

Given the objectives of the large exposure rules, we see no convincing argument here either for higher default risk compared with the Solvency Regulation.

Article 113, paragraph 1, point (f)

We wish to fully endorse the proposed rule on the treatment of intragroup exposures. The proposal duly takes into account the arguments exchanged by supervisors and the industry at CEBS level and must therefore be seen as a good compromise.

Deletion of Article 113, paragraph 3, point (m) (old)

The Financial Conglomerates Directive generally stipulates that holdings in insurance companies exceeding 20% are to be deducted from the regulatory capital. At the same time, it also states that there is no requirement to deduct holdings in insurance companies if the bank itself and the insurance company concerned belong to a recognised financial conglomerate and are included in the calculation of capital in the conglomerate. It is in this case that Article 113(3)(m) becomes important: such holdings in insurance companies are not counted towards the large exposure limits. Their exemption is also prudentially appropriate in this connection as the holdings are already supervised as financial conglomerate entities, i.e. the relevant risks are transparent and limited at conglomerate level. Dropping this exemption would result in conglomerates headed by a bank being seriously restricted in their holdings in insurance companies and transactions with prudentially non-consolidated subsidiaries and would mean their being put at a disadvantage compared with other conglomerate structures.

Deletion of Article 113, paragraph 3, point (n) (old)

Article 113(3)(n) ensures that the traditionally stably functioning liquidity distribution system within a network is not upset by any limitations in the area of the large exposures rules. Retention of the exemption of exposures which are used for liquidity distribution purposes within a network, regardless of their maturity, remains necessary despite the broader exemption in Article 80(8). Otherwise there is the danger that changes in structures or legal or other frameworks will negate the preferential effect of Article 80(8) and that the functioning liquidity distribution within a network will be disrupted.

Deletion of Article 113, paragraph 3, points (r) and (t) (old)

We are against deletion of both provisions. Banks which apply the standardised approach or the simple IRB approach to credit risk for calculating capital should be able to use the conversion factors set in the solvency rules. The conversion factors currently applying should at any rate be retained. As already ascertained in the discussion of this issue by the industry and supervisors at CEBS level, general application of a 100% conversion factor would be too conservative and mean clear interference with the current system. From a risk perspective, we do not believe that such interference is advisable. In fact, conversion factors of less than 100% are applied in around 80% of member states. At the same time, the lower weighting of off-balance-sheet items has not yet led to any problems in the area of large exposures at individual banks, so that there is no market failure. It should, in particular, be pointed out that these transactions did not trigger the present financial market crisis. Deleting these provisions would therefore be the wrong approach.

Article 113, paragraph 2

We welcome the retention of the national option with regard to the treatment of covered bonds. This treatment is appropriate because the strict requirements set in the CRD for the quality of the cover assets ensure the prime status of covered bonds at all times.

Article 114, paragraph 2

We wish to point out that in our view there is a contradiction between the provision stating that IRB banks may use the comprehensive method or the simple approach and the wording of Article 117(1)(b), as Article 117(1)(b) allows only banks applying the standardised approach to use the simple approach.

Article 115, paragraph 1

We are in favour of setting the preferential weight for exposures secured by residential property at 50%, as proposed. This is in line with the present legal situation and is risk-appropriate.

The residential property markets are seen in most EU member states as demonstrably sophisticated, long-established markets. A 50% weight is therefore justified. Should there be residential property markets in the EU which cannot be shown to meet these criteria, national

supervisors should be allowed to reduce the weight for residential property accordingly at their discretion.

This idea has already been incorporated into the proposal as far as exposures secured by commercial property are concerned. The point of reference in this connection was the preferential risk weight under Articles 78-83. This is an appropriate provision as it means that the large exposure rules only give preferential treatment to large exposures which have already met the comprehensive preferential treatment requirements under the solvency regime.

However, we should like to draw attention in this connection to another point which imposes a heavy and, in our view, unjustified bureaucratic burden in day-to-day practice. The rules in Pillar 1 and the large exposure rules contain slightly different requirements with regard to collateral providers in the case of exposures secured by residential property. Whilst the proposal made in Article 115(1), sentence 4 gears the recognition of collateral in the form of residential property to the "*borrower*", Annex VI, part 1, no. 45 refers to the "*owner*". A uniform arrangement in line with the rules in the Solvency Regulation would greatly help to reduce bureaucracy.

Article 115, paragraph 2

According to Article 115(2), final sentence, commercial property that is not fully constructed may no longer be counted towards the large exposure limits in future at a preferential weight. We reject this. The construction phase of commercial property provided as collateral is taken into account by applying a reduced market value/lending value that is regularly updated in step with construction progress and thus by assigning a correspondingly lower preferential weight under the large exposures regime. The same goes for the solvency regime, which also allows this approach. In this way, the risk of having to sell the property during the construction phase is adequately addressed. Article 115(2), final sentence should therefore be deleted.

Deletion of Article 116

In Germany, the option under Article 116, according to which interbank exposures may be assigned a 20% risk weight, regardless of their maturity, has been exercised for developments banks owned by the federal government and the *Länder*. Development banks provide their competitively neutral loans through a limited number of banks to the final borrowers (so-called "house bank principle"). In the process, the house banks usually become borrowers. Development banks generally do not have any means of intervening in or controlling the house

banks' lending process. Fully counting interbank exposures towards the large exposure limits would basically call into question the development banks' public development mandate. Development banks in particular, which provide loans only through a small number of house banks, would very quickly exceed their respective large exposure limits. According to an initial survey, the excesses of the large exposure limits, which have to be backed by capital, would erode the entire own funds of individual development banks. Given the special nature of development business and its low riskiness, we therefore believe that fully exempting development banks from application of the rules on interbank exposures under the large exposures regime is both a justified and risk-sensitive measure. To allow performance of the public development mandate, however, at least the arrangement for development banks set out in Article 116 should be retained.

In addition, we should like to point out that the preferential treatment of interbank exposures for development banks is part of the package for small and medium-sized businesses agreed within the framework of the consultations on Basel II and its implementation in Europe and has proved to be an appropriate basis for SME funding in the EU.

Article 117, paragraph 1, point (b)

We welcome the alignment of the Solvency Regulation with the large exposures regime achieved by the proposal, as it brings technical and procedural relief.

At the same time, the planned change would have unintended consequences for German development banks. In many cases, a development bank's development loan terms require the claim against the final borrower to be assigned to the development bank. This means that the interbank loan at the development bank is reduced for the purposes of the large exposures regime by the assigned amount. The borrower of the interbank loan is therefore substituted by the final borrower. However, following the envisaged change, such a substitution will only be possible if the final borrower has the same or a lower risk weight than the claim against the house bank under the Solvency Regulation. Yet this condition would not be fulfillable, so that interbank exposures would generally have to be counted in full towards the large exposure limits. Together with the envisaged deletion of Article 116, this would lead to serious restrictions on development business. Against this background, we are in favour of explicitly allowing development banks to treat the final borrower as the borrower of the development bank provided that the house bank has assigned the claim against the final borrower.

We assume that banks may also opt for the simple method for treating financial collateral.

B) Hybrid capital instruments

Article 57, point (a) (Definition of traditional Tier 1 capital)
The ZKA welcomes the principles-based additional definition of traditional Tier 1 capital. We should, however, like clarification as to whether retention of the provision of the final half-sentence ("*... but excluding ...*") of Article 57(a) is actually intended.

Article 61 (Admission of specific national write-downs and restrictions)
The ZKA wishes to point out that European harmonisation needs to be ensured. National options should therefore be avoided unless they are indispensable for achieving the desired objective of an economic level playing field. That goes particularly for sentences 1 and 2 of this Article. The ZKA welcomes the elimination of national discretion on setting lower ceilings for the eligibility of Tier 1 capital instruments. To guarantee a true level playing field across Europe, all national options which relate to the crucially important and competitively relevant issue of defining own funds should be removed. The ZKA therefore advocates deleting the first and second sentences of Article 61 in full.

Article 63a (Eligibility criteria for hybrid capital instruments)
The ZKA welcomes the European Commission's principles-based approach to regulation. Overall, the proposed rules on recognising hybrid capital instruments as Tier 1 capital duly reflect the principles of flexibility of payments, permanence and loss absorption. At the same time, they leave sufficient scope for member states to interpret them in such a way that they will be consistent with the relevant national laws. These diverge quite significantly across Europe in the key areas of company law, tax law and insolvency law, so that only principles-based regulation can ensure economic harmonisation at European level.

Article 63a, point (a), sentence 1 (Recognition of instruments with a limited life of 30 years)
The German banking community expressly endorses the Commission's proposal for the recognition of dated instruments as well. Not least in view of the fact that such instruments are admitted and recognised on, for example, the US market, the opening of Article 63a to this effect goes a long way towards creating neutral competitive conditions in the international environment. Limiting Article 63a solely to undated instruments would, in addition, unnecessarily prejudice the consultation expected at the level of the Basel Committee on Banking Supervision.

As regards the question of the minimum maturity that is to be stipulated, there is no need to explicitly focus on a fixed date such as, for example, 30 years. Besides the welcome proposal for a maturity of at least 30 years, in conjunction with the lock-in clause in sentence 7 where a bank does not comply with the regulatory capital requirements, more differentiated approaches would also be conceivable, e.g. tying a shorter minimum maturity to a so-called amortisation rule. This would provide for the non-recognition of dated instruments as Tier 1 capital in, for example, the final two years of their life, thus ensuring also in the case of dated instruments with shorter maturities that the cash is permanently available to the bank during the period of prudential recognition.

Article 63a, point (a), sentence 2 (Admission of call options after five years)

The ZKA expressly welcomes the admission of call options for Tier 1 capital instruments. However, the sentence "*It may include a call option at the sole discretion of the issuer, but it shall not be redeemed before five years (…)*" should be reworded to read "*It may include* ***call options*** *at the sole discretion of the issuer,* ***but not before five years after the issue date***".

The ZKA believes that this wording is still true to the intention of the rule. Moreover, the use of the term "*call option*" instead of "*redemption*" reflects CEBS's choice of words in its advice to the Commission. This wording will ensure that it remains possible to redeem instruments if the issuer and investor agree to do so and, above all, if the redemption is approved by supervisors after investigating the bank's financial situation. Situations like this will primarily arise when a bank issues new instruments to replace those which have been redeemed with the result that its capital position is ultimately unaffected. The wording proposed by the Commission could preclude this and not allow such redemptions before five years after the issue date.

Article 63a, point (a), sentences 4-6 (Possibility of redemption subject to supervisory approval)

The ZKA welcomes the Commission's proposed wording.

We feel, however, that sentence 5 should be followed by clarification along the following lines: "*(…) are not affected.* ***Permission can be taken for granted if the competent authorities do not refuse the request within a reasonable timeframe.*** *The competent authorities (…)*".

The additional sentence firstly makes it clear that the competent authorities need to have adequate working procedures in place. Secondly, it would ensure that banks, which plan and

carry out their issues on the basis of the prevailing market situation, can obtain supervisory approval within a reasonable period of time. If undue delay on the part of the competent authority causes the opportune time for an issue to be missed, the bank may otherwise incur considerable financial losses or it may become impossible to place the issue at all on the terms originally envisaged. To duly flesh out this provision, CEBS should draft guidelines for harmonised European implementation. These should also define quantitative rules and requirements, compliance with which will enable banks to obtain supervisory approval.

In addition, the word "*unduly*" should be inserted at the end of sentence 5: "*(…) solvency conditions of the credit institution are not* ***unduly*** *affected.*" The wording of the Commission's proposal could make it questionable if instruments may be redeemed at all subject to supervisory approval. Any redemption affects the financial or solvency situation of a bank. Even if a bank simultaneously raises fresh capital, replacement of capital instruments would still mean a structural change.

Article 63a, point (a), sentence 8 (Early redemption in the event of changes in the tax or regulatory framework)

The ZKA welcomes the Commission's proposal. However, to avoid unnecessarily restricting its scope, the term "*national tax treatment*" should be replaced by "***applicable*** *tax treatment*". This would prevent any unintended discussions of the relevant tax legislation.

For the same reason, the final part of the sentence "*(…) which was unforeseen at the issuance date.*" should be deleted. Otherwise there is the danger here, too, of unwieldy and unrewarding discussion of what was foreseeable at the issuance date and what was not.

Article 63a, point (b) (Flexibility of payments)

The proposed rules to ensure the flexibility of payments are explicitly endorsed by the German banking community. The cancellability of payments by the bank, where necessary in conjunction with the obligation for the bank to cancel payments if it does not comply with the minimum capital requirements or if the competent authority requires the cancellation of payments, are well suited to keeping the bank adequately capitalised.

Article 63a, points (c) and (d) (Loss absorption)

The principles-based definition of loss absorption on a going concern and gone concern basis is explicitly endorsed by the ZKA. Only this definition allows appropriate national implementation ensuring an economic level playing field in Europe.

Article 66 (Limits on hybrid instruments)

The proposed limit on the amount of Tier 1 capital made up by hybrid capital instruments goes much further than the requirements set out in the "Sydney Press Release (SPR)" issued by the Basel Committee in 1998. The Commission's proposal thus contradicts its own intention of transposing the SPR into European law.

Nevertheless, the proposal as a whole is a balanced compromise between the different approaches adopted by European banking supervisors. While the most important quantitative limit, 35% for "*all other instruments*", is much lower than in the SPR, it largely reflects the economic realities at banks. These do not usually use any significantly larger amounts of hybrid instruments in Tier 1 capital. Together with the higher limit for convertible instruments, the limitation of innovative instruments provided for in the SPR and the further specification of the eligibility criteria for traditional Tier 1 capital components, the Commission's proposals therefore represent a good overall package.

This clear-cut and balanced limit structure should not be diluted and unnecessarily complicated by introducing further limits.

Article 66, paragraph 1a, point (a) (50% limit for convertible instruments)

The ZKA suggests slightly amending and further specifying the rule proposed by the Commission. It should be ensured that, unless they are recognised under Article 57(a), mandatory convertibles fall within the scope of this Article. For this purpose, additional wording along the following lines would be helpful: "*(…) converted during emergency situations* ***or at a pre-determined date*** *(…)*".

In the ZKA's view, mandatory convertibles form part of traditional Tier 1 capital. They are fully paid in and are thus available for absorbing losses. What is more, they are non-redeemable, as they convert into traditional Tier 1 capital (shares) on a fixed date.

The Commission's proposal also handicaps all banks from member states whose legal regime does not allow conversion into share capital and banks whose legal form or articles of association preclude such conversion. The ZKA believes that it is sufficient if investors rank *pari passu* with holders of share capital in the event that the bank fails or experiences an emergency situation. It is not necessary in our view for them to have voting rights and participate in the profits. We therefore suggest further modifying Article 66(1a)(a) by inserting the following wording *"...Article 57*, ***or into comparable subordinated instruments which rank after all other clients for those entities where conversion into the items referred to in point (a) of Article 57 is not procurable,*** *(...)*".

Article 66, paragraph 1a (Relevant time for compliance with the limits)

Contrary to the explicit SPR requirement, which provides for compliance with the limits at the date of issuance, the limits set out in the Commission's proposal have to be complied with at all times. This proposal may serve to worsen an emergency situation at a bank, as a stress-induced reduction of traditional Tier 1 triggers a parallel reduction in eligible normal and innovative hybrid capital. We therefore continue to call for implementation of the SPR rules.

Article 66, paragraph 4 (Permission to temporarily exceed the limits)

The proposed replacement of the word "*exceptional*" should be dropped, so that this paragraph could read as follows: ***"****(...) in paragraphs 1 and 1a temporarily during* ***exceptional*** *situations.*" This would continue to ensure that the limits could be exceeded temporarily also in exceptional situations such as a merger or takeover or a capital increase at short notice. In the ZKA's view, such situations are not emergency situations, however.

Article 154, paragraph 8 (Grandfathering of limits on hybrid capital instruments)

The ZKA understands this provision to be a grandfathering arrangement for the existing limits in some member states which exceed the new limits set out in Article 66(1a). Banks holding hybrid instruments in excess of the limits in Article 66(1a) are therefore required to agree with their competent authorities on how to reduce the holdings of these instruments within the periods indicated in paragraph 9 (30 years maximum) until they comply with the new rule. Until the agreed deadlines pass, hybrid capital instruments which exceed the limits in Article 66(1a) will continue to be eligible for recognition as Tier 1 capital and will not be subject to the rule in Article 66(1a) and (d) (i.e. inclusion in Tier 2). Should this not be the

intention of the provision, we should be grateful for clarification to this effect and modification accordingly.

Article 154, paragraph 9 (Grandfathering of eligibility of hybrid capital instruments)

Our understanding is that the transitional arrangements in paragraph 9 provide for the recognition of instruments that were already issued on the date of entry into force of the directive but do not comply with the new rules. The periods and limits set out in the Commission's proposals are appropriate and provide an incentive to reduce holdings of "old" instruments, without causing any serious market disruption. They are therefore greatly welcomed by the German banking community.

Annex XII, part 2, points 3 (a) and (b) (Disclosure requirements)

The Commission's proposals provide for disclosure of a bank's capital components. This is appropriate in our view. On the other hand, identification or disclosure of old transactions that no longer meet the new requirements appears inappropriate. This would not have any additional information value for other market participants. Instead, there is the danger of market disruption. Credit rating agencies could assign instruments issued under the new rules a better quality than old issues. As a result, banks whose refinancing depends largely on an external rating by third parties might be forced into large-scale early redemption of old transactions which no longer meet the new requirements. In view of the fact that such old transactions were also subject to supervisory approval and that an appropriate procedure for their settlement is now in place, we see no need for separate disclosure of these. Confirmation by an auditor of compliance with the grandfathering rules is sufficient in our view.

For this reason, the final part of point (a) "*(…) and instruments subject to Article 154 paragraphs (8);*" should be deleted. It should refer correctly here to "*(9)*" in any case. The same goes for the final sentence of point (b) "*These disclosures shall each specify instruments subject to Article 154 paragraphs (8);*".

Directive 2006/49/EC, Article 12, subparagraph 1 (Application of the hybrid capital definition in the CAD)

In addition to the welcome parallel extension of the scope of eligible instruments in the Capital Adequacy Directive (CAD), we suggest a grandfathering clause equivalent to that in the Banking Directive. We therefore believe that reference in the CAD to Article 154(7)-(9) of the

Banking Directive is required. Without such a reference, old hybrid Tier 1 capital components exceeding the 35% limit in Article 66 would not, for example, be eligible as Tier 1 capital, though this is the case according to our above-mentioned understanding of the regulatory thrust of Article 154(8) and (9). The result would thus be friction between the Tier 1 capital provided for in the Banking Directive and the CAD respectively.

C) Supervisory arrangements

Supervision of systemically relevant branches (Article 4, paragraph 48; Article 42)

Article 42, paragraph 2 (Criteria for defining systemically relevant ranches)
The ZKA considers the criteria listed in the new paragraph 2 sufficiently comprehensive and flexible to enable systemically relevant branches to be identified. In the absence of relevant data, however, it will not be possible to set a suitable threshold above which an assessment of systemic relevance should be mandatory. It would be helpful for the competent authorities to examine on the basis of the information available to them how many and what kind of branches would be covered if the threshold were set at various levels.

Article 42, paragraph 3 (Powers of the host competent authority)
Given the way the economic importance of foreign branches has grown since the European passport was introduced, the German banking industry welcomes the plan to give more extensive information rights to competent authorities in countries where systemically relevant branches are located and involve them more closely in times of crisis. This will contribute to the stability of the financial markets by establishing greater congruence between the significance of certain parts of banks and banking groups and the information available to, and responsibilities exercised by, competent authorities in the member states where these banks or banking groups do business. It should be borne in mind that the competent authorities of foreign subsidiaries already have these rights to information and involvement although they sometimes supervise group companies which have no significant relevance to either the banking group or the country where the subsidiary is located. We would nevertheless like to point out that this change represents a partial erosion of the home country principle and a restriction on the use of the EU passport. The extension of the powers of host competent authorities should therefore be strictly confined to the areas mentioned and – as clearly indicated in sentence 7 of paragraph 2 – should not otherwise affect the division of responsibilities between the various competent authorities.

<u>Colleges of supervisors and role of the consolidating supervisor (Article 42, paragraph 4, Article 129)</u>

<u>Article 129, paragraph 3 (Establishment and composition of colleges of supervisors)</u>
We welcome the envisaged mandatory creation of colleges of supervisors. The colleges can and must help to improve the planning and coordination of supervisory activities (avoiding duplication of work; planning action on the basis of a jointly agreed group risk profile; coordination of supervisory activities to avoid capacity constraints and excessive concerted demands on a bank). Notwithstanding the high degree of harmonisation already achieved in banking supervision law, colleges can, moreover, help to promote much-needed consistency in supervisory practices and supervisory understanding within a banking group. This will become even more important with the emerging shift towards more principles-based supervision. In the interests of a level playing field, however, it is vital for all colleges to operate by the same standards. Supervisory practices should not depend primarily or substantially on where the parent company of a banking group is located. CEBS has a key role to play in furthering convergence and this should be more clearly articulated and enshrined in the directive. The current call for CEBS to prepare “guidelines for the operational functioning of colleges” does not go far enough in our view. The directive should also require CEBS to monitor whether the various colleges comply with the above guidelines in practice (especially where their responsibilities under Article 124(3) are concerned) and apply them in a consistent manner.

In addition, steps must be taken to ensure that the colleges function efficiently and that their composition is consequently determined on a case-by-case basis. To involve all the authorities responsible for supervising a banking group in all issues and activities would not only put an excessive strain on their resources but would risk rendering the work of the colleges ineffective. It is therefore essential to make a strict distinction between a general and a core college, with the latter comprising the competent authorities of those parts of the group which are relevant from a risk perspective. This distinction was made clear by CEBS in December 2007 in its “Template for a Multilateral Cooperation and Coordination Agreement on the Supervisors of xy Group”.

<u>Article 129 (Role and powers of the consolidating supervisor)</u>
Under the new version of Article 129(1)(b), the consolidating supervisor, in consultation with the other competent authorities involved, will be responsible in normal situations for planning and coordinating supervisory activities including those referred to Articles 123 and 124 and points 14 and 15 of Annex V.

The German banking industry welcomes the fact that for the first time Article 123 (ICAAP, SREP) and points 14 and 15 of Annex V (liquidity risk) are expressly mentioned.

With regard to Article 124 (monitoring of internal risk management), which the directive already refers to in its existing version, we believe that the competent authorities' joint definition of a risk profile (paragraph 1) is especially important since this is the basis for consistent planning of supervisory activities.

In addition, we see a need to spell out in more detail how the consolidating supervisor is to plan and coordinate supervisory activities. Article 129(1)(b) continues to be worded in very general terms and this often results in uncertainty, friction and suboptimal outcomes for supervision. We therefore advocate giving the consolidating supervisor clear powers vis-à-vis other competent authorities to determine planning and coordinating procedures (internal relations between competent authorities). This would not affect supervisors' relations with supervised entities (external relations).

Article 129(2) gives the consolidating supervisor the final say on whether or not to approve a group-wide rating system if the competent authorities involved are unable to reach a joint decision within six months. The proposed new version envisages consultations with CEBS (mediation) as an interim step.

This proposal is evidently an attempt to solve the problems that have arisen in connection with Article 129(2). In our view, however, the envisaged change will not achieve its objective. We are not aware of a single case so far of a consolidating supervisor exercising its right under Article 129(2) to make a final decision. The provision has thus fallen far short of the expectations placed in it at the time of its introduction. If the competent authorities fail to reach a consensus, what happens in practice is that no decision is taken at all. Banks then normally abandon the idea of having an officially recognised group-wide rating system. It is extremely doubtful whether a mediation system would effectively raise the chances of a consensus being reached. The key problem with Article 129(2) is the associated legal uncertainty. It remains unclear how legally binding the consolidating supervisor's decision would be and how it could be enforced.

Article 129(3) envisages that the consolidating supervisor would chair the meetings of the colleges and decide which other competent authorities participate in its meetings and activities. Until the consolidating supervisor is assigned more extensive powers on matters of content

(along the lines of those currently existing only for the recognition of group-wide rating systems), this strengthening of procedural authority is essential if the supervision of cross-border banking groups is to be made more consistent. The proposed change therefore has our strong support. We would also draw attention once again to our above comments on the role of the consolidating supervisor in planning and coordinating supervisory activities.

D) Waivers for cooperative bank networks

Article 3

We welcome the proposed amendment of Article 3. With convergent EU application in mind, and to avoid any disruption of the level playing field, we suggest additionally mandating CEBS to develop uniform principles for applying this provision.

With regard to the requirement to operate a system of mutual guarantees, the principles in question should stipulate that these are legally enforceable guarantees which are not subject to any condition or proviso.

In addition, we take the requirement set out in Article 3(1)(b) to mean comprehensive, centralised risk management. Continuous monitoring and reporting should enable the central body to have a full picture of all existing risk exposures at all times. Alongside centralised monitoring of risk, appropriate intervention mechanisms should be put in place for the central body to allow it to exercise network-wide control. For this, the central body needs to have directional authority in operational business not only when a crisis occurs. It must be able to exercise this authority preventatively (before excessively high risks are incurred) and limitatively (where risks already incurred threaten to deteriorate).

E) Technical amendments in the area of securitisation

We are, in general, in favour of first examining how the Basel II rules on securitisation work in practice before making any changes. Most European banks have only been applying Basel II since 1 January 2008. In consequence, no firm conclusions can yet be drawn about the risk appropriateness of the rules or their influence on the way the banks conduct their business.

We would like to reiterate our view that, to ensure a level playing field, the Basel proposals for revising the securitisation regime should not be prejudged at European level.

Article 95 (Introduction of a minimum capital charge for originator banks)
The sentence inserted into paragraph 2 requires originator banks to hold at least 15% of the risk-weighted assets (RWAs) of the securitised exposures. It is not clear how this rule is to be interpreted.

If the intention is that a certain amount of capital should be set aside to cover the bank's securitisation portfolio irrespective of the volume of retained positions, we firmly reject this proposal. There is no economic justification for imposing a capital charge for risks that have been transferred in full. What is more, such a rule would treat securitisations more unfavourably than other forms of risk transfer and there would be a danger of placing European banks at a considerable competitive disadvantage compared to their counterparts outside the EU. The rule would require capital to be set aside twice because residual risk is, to some extent at least, already deemed operational risk under Basel II. In addition, a minimum capital charge is an incentive for regulatory arbitrage.

We assume that the Commission's objective is to create an incentive to improve the monitoring of the risks arising from the exposures in the securitised portfolio. The proposed rule will have only very limited success in achieving this objective, however, and at the expense of incentives to mitigate risk completely. We would therefore suggest using qualitative requirements to counteract insufficient risk management on the part of the originator. The additional requirements for the risk management of securitisations proposed in Annex V point in the right direction in this respect. Introducing a minimum capital charge, by contrast, is not a suitable means of enforcing robust lending standards for securitisations. On the contrary, it would also affect banks that already apply sound lending standards.

It should also be borne in mind that the difficulties experienced by some European banks in recent months were caused not by securitisation but by inadequate risk measurement and management methods when investing in securitisation positions. We therefore consider it both appropriate and commensurate with the risk involved to extend, as proposed, the scope of the provision in Annex V, point 8 to cover investors.

The introduction of the 15% capital charge would also lead to a systematic divergence of economic and regulatory capital requirements, thus undermining Basel II's fundamental objective of bringing about greater convergence of these two elements.

These arguments apply equally in the event that the proposed rule is intended to encourage banks to retain securitisation positions worth 15% of their RWAs. Economic and regulatory capital requirements would continue to diverge from one another if the risks associated with the retained positions were transferred by means of hedging arrangements to a third party. And this interpretation would also give rise to further problems.

An obligation to retain securitisation positions would have serious implications for the application of IFRS accounting standards. Under IAS 37, retaining positions from a transaction is considered a continuing involvement. There is thus a danger that the assets in a true sale securitisation could not be derecognised. This portion of the loan portfolio would then have to remain on the balance sheet of the seller. The amount of assets divested to ease pressure on the balance sheet would no longer be a business policy decision but would be determined by regulatory rules. Furthermore, the retention requirement could have implications for the rules on significant risk transfer in Annex IX, Part 2.

Annex V, point 3 (Credit-granting process)

According to the additional sentence in point 3 (i), sound and well-defined standards must apply to credit granting even if the associated credit risk has been transferred or hedged by means of securitisation. This requirement is not clear. It makes no sense to apply credit granting criteria to exposures already securitised because the loan decision has also already been taken.

Paragraph (ii) then requires internal policies and economic incentives to be in place to ensure that positions intended for securitisation are also based on sound credit approval processes. Banks should consider on a case-by-case basis whether to select the exposures to be securitised

randomly or to retain positions in the securitisation transaction. Furthermore, banks should disclose their policies and internal standards.

We basically support efforts to ensure that sound lending practices are also applied to positions intended for securitisation. Nevertheless, we do not believe that shortcomings in credit approval processes in the US market should prompt further rules and regulations in the EU. Most lending institutions in the EU are banks and already subject as such to effective supervision. When portfolios are acquired for securitisation, it should therefore remain possible to apply procedures which may differ from conventional credit approval processes along the lines of the European regime for acquired exposures.

The need to disclose methods and processes is fully covered by the qualitative rules in Pillar 3, in our view. We firmly reject any disclosure requirements over and above these. What is more, internal policies and recommendations are frequently confidential and should not have to be disclosed to the entire market.

Annex VI, Part 2, point 1.4.7 (Disclosure requirements for credit rating agencies)

We are strongly in favour of specifying disclosure requirements for credit rating agencies (ECAIs) in greater detail. Supervisors have to monitor compliance with these requirements as part of the process of recognising the use of an agency's ratings for risk weighting purposes (ECAI recognition process). The banking industry currently lacks access to adequate information about the rating methodologies used by the agencies. This situation should be remedied.

We wonder, however, whether Directive 2006/48/EC is the best place to set out more extensive disclosure requirements for credit rating agencies. This directive essentially deals with capital requirements and related obligations for the banking industry. It is not up to the banks to monitor the compliance of credit rating agencies with disclosure requirements; nor are they in a position to do so.

The existing version of Annex VI, Part 2, point 1.4.7 already requires supervisors to ensure that the credit rating agencies make sufficient information about their methodologies available to the banks. In our experience, this requirement has not yet led to any significant change in the disclosure practices of the established agencies, possibly because it has only been in force for a comparatively short time. Effective monitoring of compliance with all aspects of the disclosure requirements is absolutely indispensable in our view.

<u>Annex IX, Part 2, points 1.1 and 2.2 (Definition of significant risk transfer)</u>
It is intended to standardise and spell out the criteria for what constitutes a significant risk transfer in traditional and synthetic securitisations. Two situations are described in which significant risk may be deemed to have been transferred. The first relates to transactions with mezzanine tranches and the second to transactions without mezzanine positions.

We welcome the proposed rule for situations in which mezzanine tranches are present since these represent the most common capital market transactions. But the Commission currently envisages that the competent authority may opt to judge that a significant risk transfer has not taken place even if the criteria are satisfied. This discretionary leeway for competent authorities may increase the requirements for what constitutes a significant risk transfer, which could lead in turn to an additional regulatory burden and competitive distortions. On top of that, every single transaction would have to be cleared with the competent authority in order to obtain certainty. Yet the intention of the examples is to eliminate the need for such a practice. The supervisory discretion should therefore be dropped in favour of a standard rule.

In the example dealing with securitisations containing no mezzanine tranches, a significant risk transfer is considered to have taken place if the originator can demonstrate that the exposure value of the positions which would need to be deducted from its regulatory capital substantially exceeds a conservative estimate of the expected loss on the securitised exposures and if the originator holds no more than 20% of these positions. This rule could only be applied to a very specific and rarely occurring type of transaction.

Given the wide variety of different transaction types, we reject the inclusion of the second example or of any other specific examples. We believe transactions to which the example with mezzanine tranches does not apply should be covered by the “saving provision” permitting the existence of significant risk transfer to be agreed bilaterally with the competent authority. It should also be permitted to demonstrate that a significant risk transfer has taken place by means of an internal risk measurement method which does not correspond exactly with the internal model for calculating economic capital.

We would also ask for clarification of what is meant by “*The compliance with this condition shall be periodically reviewed.*” As we see it, compliance can be ensured by procedural measures. It should be apparent from the originator’s internal records that the significant risk transfer not only existed at the time of issue, but continued to exist after completion of an action such as purchasing notes. We do not, by contrast, believe that amortisation or a rating downgrade indicates that a significant risk transfer has ceased to exist.

Annex IX, Part 4, point 3.3.48 (Treatment of super senior tranches)

The proposed changes to the CRD envisage deleting the rule that a 6% risk weight may be applied to positions in the most senior tranche of a securitisation provided that various operational requirements are met. We believe that changes to risk weights should be considered very carefully and with due regard to the overall calibration for credit quality steps and risk types. The appropriateness of a 6% risk weight for certain super senior tranches should therefore be discussed in the Basel Committee’s upcoming consultations on changing risk weights for securitisations.

F) Other technical changes

Article 87, paragraphs 11 and 12
(Exposures in the form of collective investment undertakings – CIUs)
The ZKA continues to strongly support the proposal put forward by the European Banking Industry Committees (EBIC) on the treatment of collective investment undertakings (CIUs) in the IRB approach (see EBIC's letter of 14 February 2008). We believe that the proposed method would enable the risks associated with CIUs to be handled more appropriately. What is more, it would enable the banks to streamline the related procedures quite considerably.

By contrast, the changes proposed in the Commission's working document do not, in our view, represent an adequate improvement on the current methods of calculating capital charges for investment units in the IRB approach. This is essentially because the changes offer no solution to the significant procedural problems associated with the full "look through" treatment. A further major drawback is that the proposed method would not enable equity exposures to be handled in a risk-sensitive manner. It is envisaged that the exposures would continue to be dealt with in the same way as under the simple risk-weighting approach for direct equity exposures. This consequently also fails to solve the disincentive problem which arises when banks wish to switch from the standardised to the IRB approach.

Given the serious reservations about EBIC's proposal expressed by some regulators and the Commission services, we doubt, however, whether we could succeed in convincing the Commission services of its merits in the short time available for commenting on the drafts. For this reason, we would like to suggest the following changes using the Commission's proposal as a basis. We believe that this is considerably more risk appropriate than the "simplified look through" for non-equity exposures under Article 87(11)(2)(b). Introducing multiplication factors of 1.1 and 2 would result in having to set aside less capital for securities with better ratings and more capital for higher risks than is the case under the existing rules. We understand the Commission's concern that a multiplication factor of 1.1 for low-rated or unrated exposures would risk encouraging banks using the IRB approach to move high-risk exposures into CIUs. Nevertheless, a multiplication factor of 2 will not always be necessary to prevent this happening. In our view, a factor of 2 exaggerates the risk associated with exposures with the second-lowest rating. We therefore advocate deleting the elements in square brackets ("*[two]*" and "*[s]*") from the proposed Article 87(11)(2)(b)(i) so that factor 2 would apply only to the lowest rating category. Factor 2 is over-conservative for unrated exposures too. If such exposures are assumed to have an average credit quality (on the borderline between investment and non-investment grade) and if the greater degree of "non-

knowledge" about their real credit quality is taken into account, a risk weight of 150% would be appropriate in our view. Investments in sovereign, bank and corporate securities with the above ratings would still be subject to higher capital requirements than under the present rule. This is illustrated in the following summary:

Central governments			
Rating	**Existing rule**	**Commission proposal**	**ZKA proposal**
B+ to B-	150%	200%	110%
CCC+ and below	200%	300%	300%
unrated	100%	200%	150%
Banks/regional governments and local authorities			
Rating of country of location	**Existing rule**	**Commission proposal**	**ZKA proposal**
B+ to B-	150%	200%	110%
CCC+ and below	200%	300%	300%
unrated	100%	200%	150%
Corporates			
Rating	**Existing rule**	**Commission proposal**	**ZKA proposal**
B+ to B-	150%	300%	165%
CCC+ and below	200%	300%	300%
unrated	100%	200%	150%

Article 89, paragraph 1, point (d) ("*exposures to central governments of the Member States and their regional governments, local authorities and administrative bodies*")
We strongly support the proposed rule, which is appropriate to the associated risk and will establish a level playing field in Europe.

Article 150, paragraph 1, point (m) (Comitology procedure for large exposure limits)
This envisages setting large exposure limits under the comitology procedure. We have strong reservations about this proposal. As the current discussion of large exposure rules has shown, even the smallest changes to single components can have a considerable effect on individual banks. For this reason, future changes should continue to be made with the involvement of the European Commission, Council and Parliament. We are therefore in favour of dropping the proposed additional provision in Article 150(1)(m).

Annex III, Part 2, point 3 and Annex II, point 11 (Introduction of an option for calculating capital requirements for CCR for certain credit derivatives)

We welcome the introduction of the proposed option for banks. This will ensure that banks using internal model methods to calculate counterparty credit risk will be in a position to properly reflect netting effects.

Annex VIII, Part 1, point 16

We would like to suggest inserting the following additional wording for clarification purposes: "*When the exposure is a residual value of leased properties* ***and is not taken into account in the lease exposure value as calculated above****, the risk weighted exposure amounts shall be calculated as follows: (…)*".

Annex VII, Part 1, point 1.3.3.25 (Calculating risk-weighted exposure amounts for equity exposures under the internal models approach)

The current rule requires the floor for calculating the risk-weighted exposure amounts for equity exposures under the internal models approach to be determined on an individual basis. Applying the floor at the equity portfolio level as in the proposed new rule is both appropriate and consistent with a VaR approach. The proposal therefore has our full support.

Annex VII, Part 2, point 1.3.13 (c) (Calculating M for exposures from fully or nearly fully collateralised derivative instruments)

We welcome the plan to reduce the minimum M from ten to five days for exposures arising from fully or nearly fully collateralised derivative instruments. This is in line with the corresponding Basel II rule.

Annex VII, Part 4, point 2.2.4.96 (Minimum requirements for estimating the effect of guarantees and credit derivatives – extension of the non-application of points 97 to 104 to certain corporate entities)

Extending the exemption from the requirements in points 97 to 104 to cover corporate entities is an appropriate step in our view. We therefore support the planned change.

Annex VIII, Part 1, points 1.3.1.9 and 1.3.2.11 (Recognition of collective investment undertaking (CIU) units as collateral

The possibility for certain assets in CIU funds to be recognised as collateral is highly welcome. We would nevertheless like to point out that the requirement to deduct negative values does not reflect market practices. Only derivatives can have negative market values and these are taken into account when the CIU manager calculates the undertaking's net asset value. It therefore makes little sense, in our view, to require their deduction.

Annex VIII, Part 2, point 1.8.2.13 (Minimum requirements for the recognition of life insurance policies pledged to the lending bank)

We regard the planned changes as a significant improvement on the status quo. The deletion of the reference to the requirements for a minimum credit quality for other corporate entities in Annex VIII, Part 1, point 26 is particularly welcome because this better reflects the character of a pledged insurance policy as collateral. Unlike with a guarantee, the quality of the collateral is not determined primarily by the creditworthiness of the guarantor.

Annex VIII, Part 2, point 2.2.16 (Extension of the eligibility of counter-guarantees)

Counter-guarantees by international organisations with a 0% risk weight under the standardised approach are of equally high quality as those provided by already eligible guarantors. We therefore welcome the plan to accord these counter-guarantees equal treatment.

Annex VIII, Part 3, point 1.4.1.24 (Simultaneous use of the financial collateral simple and comprehensive methods)

We agree that it is appropriate in the situations mentioned to permit the financial collateral simple method and the financial collateral comprehensive method to be used at the same time. However, the requirement to demonstrate that this new option is not being abused for regulatory arbitrage purposes will be difficult to comply with and excessively onerous, in our opinion. If the two methods are used simultaneously in the context of temporary partial use under Article 85(1), we do not consider it absolutely necessary to provide the required evidence for the brief period until the IRB approach has been implemented in full. In the context of permanent partial use under Article 89(1), the exposures involved will inevitably be immaterial and thus generate only minor capital charges. This means that the difference between using the simple and comprehensive method will be so insignificant as to make the furnishing of evidence unwarranted. We therefore suggest dropping this requirement.

Annex VIII, Part 3, points 1.4.1.26, 1.4.1.33, 1.5.2.69, 2.2.2.87, 2.2.2.88, 2.2.3.90, 2.2.3.91 and 2.2.3.92 (Clarification that credit risk mitigation effects are to be calculated before the application of a conversion factor)

In the interests of a level playing field in Europe, we welcome the clarification of the above points. It is unacceptable, in our view, for national rules on calculating these credit risk mitigation effects to differ across member states.

Annex VIII, Part 3, point 1.5.2.75 (Alternative treatment of real estate collateral under the standardised approach when using regulatory LGD calculation methods)

We assume that this rule has merely been reworded and would appreciate clarification that there is no change to the substance of the rule. A change would not be appropriate in our view because the existing rule is needed to ensure a level playing field.

Annex VIII, Part 3, point 1.7.2.80 (Life insurance policies as collateral – risk weights in standardised approach and regulatory estimates of LGD)

The planned regulatory LGD of 40% is disproportionate in our view given the 45% LGD assigned to senior unsecured exposures. A figure of 35% would be more appropriate and better reflect the risk mitigating effect of the collateral. This can be seen from a comparison with the regulatory LGD floor for receivables since the surrender value of a life insurance policy could be interpreted as a claim by the bank on the insurance company.

Insurance policies pledged as collateral are first and foremost a feature of retail banking, which in Germany covers not only personal customers but also a large number of SMEs. It is common practice in this latter segment to use life insurance policies as collateral. Unsecured retail exposures are assigned a risk weight of 75% in the standardised approach. As things stand, the proposed rule in point 1.7.2.80(c) would assign an exposure fully secured with an insurance policy a risk weight of 70%, i.e. only 5 percentage points lower. This fails completely to reflect the obvious risk-mitigating effect of the pledged life insurance policy. In view of the strict minimum requirements set out in Annex VIII, Part 2, point 1.8.2.13 and the high quality of life insurance products as collateral, we consider a risk weight of 50% at most to be commensurate.

Directive 2006/49/EC (CAD), Articles 45 and 48 (Extension of the national option to exempt investment firms from the large exposures regime and capital requirements)

Article 45 of the CAD currently gives national competent authorities the option to exempt investment firms from the large exposure limits until 31 December 2010. Article 48 of the CAD permits certain types of investment firm to be exempted from all capital requirements. These national options put banks at a massive competitive disadvantage. Banks operate on the same markets as investment firms. There is no discernible reason why the risks assumed by an investment firm should be considered less serious than those assumed by a bank for the same type of transaction. The proposal to extend the already generous exemption period by another two years is consequently all the more surprising. To avoid additional competitive disadvantages for the banking industry, we would urge the Commission not to pursue further the idea of extending the exemption arrangements in Articles 45 and 48 of the CAD.

Directive 2006/49/EC (CAD), Annex 1, point 8. B (Position risk – treatment of protection buyer in first-to-default and n^{th}-to-default credit derivatives)

The question of how to treat protection buyers in the case of first-to-default and n^{th}-to-default credit derivatives when calculating position risk was explored by the CRD Transposition Group (question 171). The existing rule cannot be applied satisfactorily to first-to-default credit derivatives because it is not possible to offset specific risk for credit derivatives of this kind. We therefore basically welcome the new rule. Nevertheless, we consider it unnecessarily conservative to calculate the protection effect on the basis of the reference entity with the lowest percentage capital charge, i.e. with the lowest risk of default. The protection effect would be reflected more appropriately by basing calculations on the unit with the highest percentage capital charge. That this method produces economically sound results is evidenced by the fact that the market also bases the pricing of these credit derivatives on the underlying with the highest risk of default.

Directive 2006/49/EC (CAD), Annex V and Article 47 (Use of internal models to calculate capital requirements in the trading book – incremental default risk)

The basis for the ongoing discussion of this issue was originally the Basel Committee's consultation document of 12 October 2007, "Guidelines for Computing Capital for Incremental Default Risk in the Trading Book". On 16 April 2008, however, the committee announced its intention to extend the scope of the planned guidelines to cover the event risks which played a role in the subprime crisis. The consultation document is now being revised.

This will probably result in major changes to the modelling requirements for banks. According to our information, however, the work by the Basel Committee is as yet in its infancy. The first step will be to draft extended guidelines, which will then be published for international consultation. There will also be a global quantitative impact study on the revised guidelines. The findings of this study will be taken into account when the quantitative parameters for calculating capital charges are ultimately set.

Against this backdrop, we welcome the European Commission's decision to refrain at this stage from adjusting the rules in Annex V of the CAD to reflect the present status of discussion in the Basel Trading Book Working Group. As mentioned in our introductory remarks, the directive's rules should be revised only after the corresponding guidelines have been adopted by the Basel Committee.

The plans to finalise the work by the Basel Committee by the end of 2008 are highly ambitious in our view. It is therefore likely to be difficult to carry out the changes to Annex V in the course of the current CRD review. And even if this did prove possible, the new event and default risk models could not, by the end of 2009, be developed and internally validated by the banks, rolled out to satisfy the use test requirement, and examined and approved by the competent authorities. The problem is compounded by the fact that, in addition to modelling the area of interest rate risk, the development of event and default risk models for equity products must first become established.

There is consequently a pressing need to adjust the transition period in Article 47 of the CAD. We would suggest an extension of two years until 31 December 2011. Banks which have a model ready for submission to the competent authority before this date should be encouraged to apply for recognition before the deadline. This two-year extension will not pose any problems, in our opinion, since we assume that the planned interim solution will ensure that banks have an adequate capital cushion to cover their trading book activities even before their event and default risk models are approved.

We would also like to draw attention to the letter of 26 March 2008 from the European Banking Industry Committee (EBIC) to the European Commission. In this letter, EBIC urges the Commission to revisit the parameters of the one-year capital horizon and the assumption of a simple addition of incremental default risk charge. We would like to take this opportunity to reiterate the letter's recommendation to consider introducing a simplified supervisory model for event and default risk. This would enable special characteristics of European banks to be taken into account. Small banks need a model of this kind to keep the time and effort involved

in its implementation within acceptable limits. The model could, in particular, contain regulatory parameters for calculating short-term probabilities of default within one year and rules on asset correlations. It is also important to bear in mind the needs of small banks which specialise in trading and have a modest, or even no, banking book. These banks normally use the standardised approach and so have no internal PD estimates on which to base estimates of short-term PDs. It would be desirable to allow the use of PDs calculated by credit rating agencies in such cases.

Annex X, Part 3, point 1.2.2.14 (Additional business line for corporate items)

We warmly welcome the introduction of an additional business line “corporate items”. This will enable loss events affecting the entire bank to be allocated in an appropriate manner.

III. Replies to the questions in the discussion paper

A) Large exposures

The Commission services are interested in learning stakeholders' views on the impact, if any, of the approach suggested above.
With regard to interbank exposures, a limit is suggested that represents the higher of 25 % of a bank's own funds or Euro "X" million (the Committee of European Banking Supervisors has suggested that 'X' should be set at Euro 150 million). Stakeholders' views are sought on the appropriateness of a Euro 150 million limit for exposures to institutions, and on the impact of this suggestion for banks' funding requirements on a day-to-day basis as well as during a contingency.

Because of the systematic competitive handicap for smaller banks and as these do not generate any systemic risk, establishment of a volume-based threshold for interbank exposures regardless of their maturity – as already provided for under the current proposal – would be appropriate. A suitable limit cannot, however, be less than €300 million.

At the same time, to ensure the functioning of the money market and thus the provision of liquidity to banks, the exemption of interbank exposures in the 0-1 year time band should definitely be retained.

B) Hybrid capital instruments

Do stakeholders agree with:
(i) the Commission services' suggested eligibility criteria and the principle-based approach suggested above?
(ii) the recognition of dated instruments - with a predetermined minimum original maturity - in firms' original own funds?
(iii) the quantitative limits suggested? In this respect, the Commission services are also interested in views whether an additional limit would be useful to improve even further the quality of capital e.g. by requiring firms' core capital (equity, reserves and retained earnings) to be higher than a pre-determined proportion (e.g. 50 %) of minimum capital requirements?

(i) Eligibility criteria and principles-based approach
The ZKA welcomes the European Commission's principles-based approach to regulation. Overall, the proposed rules on recognising hybrid capital instruments as Tier 1 capital duly reflect the principles of flexibility of payments, permanence and loss absorption. The same

goes for the principles-based further specification of the requirements for traditional Tier 1 capital in Article 57(a). At the same time, the proposed rules leave sufficient scope for member states to interpret them in such a way that they will be consistent with the relevant national laws. These diverge quite significantly across Europe in the key areas of company law, tax law and insolvency law, so that only principles-based regulation can ensure economic harmonisation at European level.

(ii) Recognition of dated instruments

The ZKA also expressly endorses the Commission's proposal for recognition of dated instruments in Tier 1 capital. This new arrangement will give banks access to a broad new investor base, which, under existing hybrid instrument rules, comprises mainly retail clients. Institutional investors, on the other hand, prefer investments in instruments with a predetermined maturity. The possibility to issue dated instruments therefore creates more efficient markets, in this way greatly improving the terms on which banks can raise fresh capital even in difficult market situations. In addition, the recognition of dated instruments helps to limit distortions of competition also in an international context. In the United States, for example, instruments with long maturities have already been recognised in Tier 1 capital for many years. Against the background of the upcoming review of the definition of capital by the Basel Committee on Banking Supervision, the proposed rule also creates further scope for negotiation for stakeholders.

(iii) Appropriateness of quantitative limits

The proposed limit on the amount of Tier 1 capital made up by hybrid capital instruments goes much further than the requirements set out in the "Sydney Press Release (SPR)" issued by the Basel Committee in 1998. The Commission's proposal thus contradicts its own intention of transposing the SPR into European law. Nevertheless, the proposal as a whole is a balanced compromise between the different approaches adopted by European banking supervisors. While the most important quantitative limit, 35% for "*all other instruments*", is much lower than in the SPR, it largely reflects the economic realities at banks. These do not usually use any significantly larger amounts of hybrid instruments in Tier 1 capital. Together with the higher limit for convertible instruments, the limitation of innovative instruments provided for in the SPR and the further specification of the eligibility criteria for traditional Tier 1 capital components, the Commission's proposals therefore represent a good overall package. This clear-cut and balanced limit structure should not be diluted and unnecessarily complicated by introducing further limits.

C) Supervisory arrangements

The Commission services seek views on the proposed amendments relating to crisis management and home/host issues. In particular, views are sought on the definition of a systemically relevant branch and an appropriate level for the threshold in Article 42(2).

Given the extent to which the economic importance of foreign branches has grown, the German banking industry welcomes the proposal in Article 42(3) to give more extensive information rights to competent authorities in countries where systemically relevant branches are located and involve them more closely in times of crisis. We would nevertheless like to point out that this change represents a partial erosion of the home country principle and a restriction on the use of the EU passport. The extension of the powers of host competent authorities should therefore be strictly confined to the areas mentioned and should not otherwise affect the division of responsibilities between the various competent authorities.

The German banks welcome the creation of colleges of supervisors. In the interests of a level playing field, however, it is important for all colleges to operate by the same standards. The current call for CEBS simply to prepare "guidelines for the operational functioning of colleges" does not go far enough in our view. The directive should also require CEBS to monitor whether the various colleges comply with the above guidelines in practice and apply them in a consistent manner. In addition, steps must be taken to ensure that the colleges function efficiently and thus that their composition is determined on a case-by-case basis.

We see a need to spell out in more detail how the consolidating supervisor is to plan and coordinate supervisory activities (Article 129(1)(b)). We therefore advocate giving the consolidating supervisor clear powers vis-à-vis other competent authorities to determine planning and coordinating procedures (internal relations between competent authorities). This would not affect supervisors' relations with supervised entities (external relations).

In the absence of relevant data, it will not be possible to set a suitable threshold above which an assessment of systemic relevance should be mandatory. We would suggest that the competent authorities examine on the basis of the information available to them how many and what kind of branches would be covered if the threshold were set at various levels.

D) Waivers for cooperative bank networks

In your view should affiliates to networks meeting the eligibility criteria laid out in the CRD but set up after 15 December 1977 be allowed to make use of the same exemptions as the affiliates to networks set up before that date?

Yes. We welcome the proposed amendment of Article 3. With convergent EU application in mind, and to avoid any disruption of the level playing field, we suggest additionally mandating CEBS to develop uniform principles for applying this provision.

E) Technical amendments in the area of securitisation

In the context of securitisation, views are sought on the effectiveness of the proposed changes in improving risk management and making appropriate adjustments to certain capital treatments.

The additional rules in Annex V should ensure that loans earmarked for securitisation are also subject to a rigorous approval process. In our view, appropriate implementation of these rules has the potential to eliminate the evident shortcomings of risk management methods at some banks. We also consider the inclusion of investors in the scope of Annex V, point 8 a suitable means of improving risk measurement and risk management of investments in securitisation positions.

By contrast, we reject the proposed introduction in Article 95 of a minimum capital charge for originators amounting to 15% of the risk-weighted assets in the securitisation portfolio. There is no economic justification for imposing a capital charge for risks that have been transferred in full. What is more, such a rule would treat securitisations more unfavourably than other forms of risk transfer and there would be a danger of placing European banks at a considerable competitive disadvantage compared to their counterparts outside the EU. On top of this, the rule would have no discernible influence on the quality of the lending process and on monitoring the risks associated with the securitisation portfolio. Instead, it would create an incentive for regulatory arbitrage.

The proposals concerning qualified liquidity facilities and the deletion of the 6% risk weight for super senior tranches should be discussed in the Basel Committee's upcoming consultations on these issues. The rules on securitisations, especially the risk weights for credit quality steps, are highly risk sensitive. Since it is important to have an appropriate overall

calibration of capital requirements for securitisations, a holistic approach is needed to any planned changes.

F) Other technical changes

The Commission Services seek views on the above technical changes and if they achieve the aim of clarifying or correcting the respective provisions of the directive. In particular, views are sought on the adjusted treatments for:

- *CIUs under the IRB in Article 87(11) and (12) and in particular on the calibration of the factors in square brackets;*

The ZKA continues to strongly support the proposal put forward by the European Banking Industry Committees (EBIC) on the treatment of collective investment undertakings (CIUs) in the IRB approach (see EBIC's letter of 14 February 2008). We believe that the proposed method would enable the risks associated with CIUs to be handled more appropriately. What is more, it would enable the banks to streamline the related procedures quite considerably.

By contrast, the changes proposed in the Commission's working document do not, in our view, represent an adequate improvement on the current methods of calculating capital charges for investment units in the IRB approach. This is essentially because the changes offer no solution to the significant procedural problems associated with the full "look through" treatment. A further major drawback is that the proposed method would not enable equity exposures to be handled in a risk-sensitive manner. It is envisaged that the exposures would continue to be dealt with in the same way as under the simple risk-weighting approach for direct equity exposures. This consequently also fails to solve the disincentive problem which arises when banks wish to switch from the standardised to the IRB approach.

Given the serious reservations about EBIC's proposal expressed by some regulators and the Commission services, we doubt, however, whether we could succeed in convincing the Commission services of its merits in the short time available for commenting on the drafts. For this reason, we would like to suggest the following changes using the Commission's proposal as a basis. We believe that this is considerably more risk appropriate than the "simplified look through" for non-equity exposures under Article 87(11)(2)(b). Introducing multiplication factors of 1.1 and 2 would result in having to set aside less capital for securities with better ratings and more capital for higher risks than is the case under the existing rules. We understand the Commission's concern that a multiplication factor of 1.1 for low-rated or

unrated exposures would risk encouraging banks using the IRB approach to move high-risk exposures into CIUs. Nevertheless, a multiplication factor of 2 will not always be necessary to prevent this happening. In our view, a factor of 2 exaggerates the risk associated with exposures with the second-lowest rating. We therefore advocate deleting the elements in square brackets ("*[two]*" and "*[s]*") from the proposed Article 87(11)(2)(b)(i) so that factor 2 would apply only to the lowest rating category. Factor 2 is over-conservative for unrated exposures too. If such exposures are assumed to have an average credit quality (on the borderline between investment and non-investment grade) and if the greater degree of "non-knowledge" about their real credit quality is taken into account, a risk weight of 150% would be appropriate in our view. Investments in sovereign, bank and corporate securities with the above ratings would still be subject to higher capital requirements than under the present rule. This is illustrated in the following summary:

Central governments			
Rating	**Existing rule**	**Commission proposal**	**ZKA proposal**
B+ to B-	150%	200%	110%
CCC+ and below	200%	300%	300%
unrated	100%	200%	150%
Banks/regional governments and local authorities			
Rating of country of location	**Existing rule**	**Commission proposal**	**ZKA proposal**
B+ to B-	150%	200%	110%
CCC+ and below	200%	300%	300%
unrated	100%	200%	150%
Corporates			
Rating	**Existing rule**	**Commission proposal**	**ZKA proposal**
B+ to B-	150%	300%	165%
CCC+ and below	200%	300%	300%
unrated	100%	200%	150%

- *Life insurance as collateral and whether the risk weights and supervisory LGD are commensurate with the additional protection due to the preferential status of a life insurance claim compared to a "normal" claim on the insurance provider.*

The planned regulatory LGD of 40% is disproportionate in our view given the 45% LGD assigned to senior unsecured exposures. A figure of 35% would be more appropriate and better

reflect the risk mitigating effect of the collateral. This can be seen from a comparison with the regulatory LGD floor for receivables since the surrender value of a life insurance policy could be interpreted as a claim by the bank on the insurance company.

Insurance policies pledged as collateral are first and foremost a feature of retail banking, which in Germany covers not only personal customers but also a large number of SMEs. It is common practice in this latter segment to use life insurance policies as collateral. Unsecured retail exposures are assigned a risk weight of 75% in the standardised approach. As things stand, the proposed rule in point 1.7.2.80(c) would assign an exposure fully secured with an insurance policy a risk weight of 70%, i.e. only 5 percentage points lower. This fails completely to reflect the obvious risk-mitigating effect of the pledged life insurance policy. In view of the strict minimum requirements set out in Annex VIII, Part 2, point 1.8.2.13 and the high quality of life insurance products as collateral, we consider a risk weight of 50% at most to be commensurate.