

Position Paper of the Association of German Banks on Appropriate Capital Rules

The global regulatory environment is currently undergoing upheaval. Under the political leadership of the G20, a reform programme that is vitally important for restoring the stability of the worldwide financial system has been launched in response to the crisis. The focus of international efforts to implement reforms is on systemic risk, which has been neglected to date. To limit this risk, the prevailing microprudential supervisory paradigms need to be supplemented by macroprudential elements. As a consequence, not only supervisory rules but also the institutional architecture for supervision have to be reviewed. Both rules and supervisors must take the procyclical dynamics of the financial system into account.

Against this backdrop, we welcome the current discussion on improving the capital adequacy of banks. This discussion is necessary so that the right lessons can be learned from the causes and consequences of the ongoing crisis. Internationally agreed measures to strengthen banks' crisis resilience and mitigate procyclical effects are required.

To this end, pinpointed, balanced reform of the new capital adequacy framework for banks (Basel II) is needed. At the same time, there should be consensus that to achieve the envisaged system stability there is no alternative to consistently risk-sensitive rules such as those created under Basel II. Just as important as revision of Basel II is its uniform implementation worldwide. We reject any moves to generally call into question or shelve Basel II. However, a risk-sensitive capital regime inherently entails procyclical effects that have to be alleviated by adopting suitable measures.

The call for better **system-wide capital adequacy** of banks meets with broad approval. We, too, welcome measures designed to improve banks' crisis resilience. There is a need for stronger capital buffers which take into account risks specific to individual types of transaction and risks specific to individual banks. We therefore support in particular efforts by rulemakers to adjust capital requirements specifically in areas which have been shown during the crisis to understate risk.

Any additional measures must be examined against the impact of the reform steps already launched. A limitation of regulatory capital to particularly high-quality capital components is also under discussion. Rules which lead to a system-wide increase in the level of capital requirements should not be implemented until the crisis is over, however, as such an increase would exacerbate the present situation.

In addition, measures designed to limit business growth are being discussed to an increasing extent. Supplementing risk-based capital requirements with a leverage ratio intended as a further limitation would, however, encounter considerable practical problems when implemented, especially in an international context, and therefore seems unlikely to work. Examples of such problems are the lack of comparability due to differing accounting standards or the creation of disincentives, particularly the discrimination of low-risk transactions. All the same, if designed appropriately as a business growth indicator, the introduction of a leverage ratio could deliver useful early-warning information.

The German private banks take a critical view, however, of any undifferentiated blanket increases in capital levels across all types and classes of risk. Blanket increases would seriously restrict the business activity of all banks and thus limit the supply of credit, with negative consequences for the economy as a whole.

We strongly welcome **measures to mitigate procyclical effects** of the prudential regime. Particularly dynamic provisioning or buffering delivers the desired results. During upward economic phases, provisioning for future loan losses should be conducted in the form of capital buffers that can then be liquidated in downward phases. To avoid jeopardising the effectiveness of such buffers, it must be ensured when designing these in practice that the provisions or reserves created do not affect Tier 1 capital.

Approaches which adjust calculation of risk-weighted assets (RWAs) in the course of the business cycle and thus have a countercyclical effect (systematic increase in RWAs in a boom, reduction in a slump) also make sense. The central problem posed by most of these approaches is, however, the timing of the increase or reduction in capital requirements. Moreover, there would have to be uniform global standards for deciding which phase of the cycle an economy is in.

In addition, amendments to accounting rules that facilitate the admissibility of alternative valuation methods for illiquid assets could reduce the pressure on banks' balance sheets immediately. Against the backdrop of inactive markets, it should be made easier for banks to use alternative methods of valuing financial instruments instead of marking them to market.

The proposals outlined briefly in this position paper are explained in more detail in a discussion paper on appropriate capital rules, which is available on request from the Association of German Banks (sekretariat.bankenaufsicht-bilanzierung@bdb.de). This discussion paper also looks at and assesses further regulatory proposals under consideration at international level.¹ To allow easier reference, the following overview sets out its findings.

¹ The discussion paper also goes into an issue of purely national interest, namely the implementation in German law of the application of the prudential filter to the revaluation reserve. Analysis of this measure has been omitted from the current version of our position paper.

Rating of measures under discussion to overhaul bank capital adequacy rules

<p>● = fully achieved/positive assessment</p> <p>◐ = partially achieved/ambivalent assessment</p> <p>○ = not achieved/negative assessment</p>	Level of achievement of intended effect	Implementability of proposal	Appropriateness of proposal	Overall rating by Association of German Banks*
Measures to improve crisis resilience (capital buffers)				
Risk-sensitive adjustment of capital requirements for certain areas	●	●	◐	●
Leverage ratio	◐	◐	◐	◐
Capital surcharge in Pillar 2	◐	●	○	○
Capital adequacy following stress tests	◐	◐	○	○
General increase in capital level	◐	●	○	○
Measures to mitigate procyclical effects				
Dynamic provisioning	●	◐	●	●
Non-inclusion of revaluation reserve in regulatory capital	◐	●	●	●
Easier applicability of alternative valuation methods	◐	◐	●	●
Separate calculation of regulatory capital	◐	◐	○	○
Loan growth-driven RWA surcharge	●	◐	●	◐
Cyclical amendment of scaling factor or confidence level	●	○	●	◐
Mandatory use of TTC estimates	●	○	◐	○
Sliding RWA average	◐	◐	◐	◐
Downturn PD	○	●	○	○

* The overall rating not only comprises an assessment of the individual criteria (columns 2-4) but also takes into account other factors such as consistency with existing supervisory practice, risk-related aspects and business considerations.