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Consultation paper on technical aspects of the management of interest rate risk arising from non-trading activities and concentration risk under the supervisory review process - CP 11

Dear Sir or Madam,

In March 2006, the Committee on European Bank Supervisory Authorities presented a revised consultation paper on the handling of interest risks ("Consultation paper on technical aspects of the management of interest rate risk arising from non-trading activities and concentration risk under the supervisory review process – CP 11"). In the paper it was stated that there is an opportunity to submit comments by June 23, 2006 is provided and a request was made for any further technical comments to be submitted to the appropriate national bank supervisory authorities and central banks. With this letter we wish to inform you of the comments of the German banking industry regarding the aforementioned consultation paper and request you to take these into account in further discussions.

Part 1: Interest rate risks in the banking book

First, it must be noted that the regulations proposed in the consultation paper are very detailed and prescriptive. The necessary freedom in the management of the IRRBB must not be restricted. The banks should be allowed to do more on their own responsibility and granted the freedom to choose their own methods in process design as part of the minimum requirements specified by the CRD. In Germany this principle has been taken into account in the implementation of the second pillar of the EU specifications.

Among other things, the requirement of Paragraph 19, according to which the supervisory authorities should, if necessary, require additional regulatory capital for the IRRBB using their own methods and not on the basis of those used by the banks, is in contradiction to the principle of the banks' freedom to select the methods they use. The possibility specified in IRRBB 1 of requiring that the institutions use a method of calculation of the changes in economic value defined by the supervisory authorities is questionable in this

context. Nonetheless we welcome the flexibility of supervisory measures expressed in several places in the consultation paper. In this regard we refer to Paragraph 1, which states that a calculation of the interest rate risk in the banking book pursuant to Pillar II can be tailored especially to the relevant institution.

Experiences in practice have shown that components, forms of organisation or risk management process workflows listed as examples are understood by the auditors as quasi-compulsory minimum standards. Thus the lists of examples given in Paragraphs 9 and 10 should be deleted.

The regulations regarding the IRRBB papers should also be designated explicitly as part of the ICAAP and SREP. In particular, it should be clarified that all risks are covered by an ICAAP accepted by the supervisory authorities and the supervisory authorities cannot take any other measures in this regard.

We wish to submit the following comments on individual aspects of the consultation paper.

▪ **Paragraph 3: Overlaps with accounting requirements**

Paragraphs 2 and 3 refer to the contextual correspondence between IFRS (requires among other things the sensitivity analysis for the interest rate risk of financial instruments) and requirements of the supervisory authorities with regard to the IRRBB, and explain that CEBS must possibly deal with the issue again at a later point in time. In order to keep the administrative burden on the institutions as low as possible, the procedures/analyses required for accounting should be recognised as far as possible for bank supervisory purposes. -Conflicts between supervisory law and accounting regulations can be avoided with sufficiently flexible bank supervisory specifications for dealing with interest rate risks. In this regard we consider the description of the IAS 39 issue in Paragraph 3 to be superfluous.

▪ **Paragraph 5: Definition**

We are pleased that CEBS acknowledges the method of measuring the interest rate risk based on "economic value" as well as on "earnings". However, a definition of the IRRBB linked to both methods is problematic in view of the requirements that follow from the definition. In conformity with IRRBB 1 it should be made clear that a P&L-based view is not obligatory and that the institutions can choose which of the two methods they wish to use.

Uniform terminology should also be used with regard to these two factors. Thus Paragraph 5 contains the unclear formulation "earnings and capital reductions", while below "earnings" and "current market value" are more precisely differentiated. In Paragraph 18 the term "net worth" should also be adapted.

- **Paragraph 6: Valuation perspectives of the IRRBB**

In Paragraph 6 the importance of the profit and loss statement as well as the cash value (market value) view of the IRRBB is emphasised. Please refer to our comment regarding Paragraph 5.

- **Paragraph 9: Risks assigned to IRRBB**

In Paragraph 9, CEBS lists risks that the institutions currently assign to their IRRBB. In order to preclude any indirect binding effect, the list should be deleted or the ~~risk~~ components listed should be designated explicitly as examples.

- **Paragraph 10: Instruments used to measure and monitor IRRBB**

Paragraph 10 lists the instruments that banks "usually" use, according to CEBS, to measure and monitor their IRRBB. In order not to restrict the necessary flexibility in risk management via any indirect binding effect that may arise from such lists, the list of instruments should be deleted.

- **Paragraph 14: Organisation of the IRRBB management**

Paragraph 14 describes the organisational structure of IRRBB management. We suggest to rephrase the paragraph stating that the IRRBB management in general has to comprise the strategic function, the operative functions as well as an independent risk monitoring. The delegation of these functions should explicitly be left at the disposition of the individual institution. It should at least be clarified that the form of organisation described is only an example.

- **Paragraph 19: Requirements for the supervisory authorities**

Among other things, Paragraph 19 obligates the supervisory authorities to develop suitable approaches for the establishment of the necessary additional regulatory capital for IRRBB. It should be made clear that the supervisory authority will not impose any further capital requirements if the IRRBB was quantitatively and qualitatively modelled in an ICAAP process to which no objections were raised. This should apply to all relevant risks of Pillar II.

Furthermore, the statement regarding the "*standard practice of requiring own additional own funds*" in conjunction with the Pillar II risks is confusing. It should be made clear that additional regulatory capital for the IRRBB as part of ICAAP may be required only as a last resort.

In the 6th level, the "absolute or relative size of the non-trading activities" is mentioned in connection with the principle of proportionality. In line with the proven terminology and philosophy of the "minimum requirements for risk management (MaRisk)", which represent the specification of Pillar II in Germany, we propose applying this to the type, size, complexity and riskiness of business.

- **Paragraph 20: Reporting the IRRBB**

The larger banks in particular are already subject to extensive disclosure requirements. It should be ensured that no additional requirements arise from the requirements for IRRBB management.

- **Paragraph 21: Calculation methods**

Paragraph 21 mentions the expectation that the institutions must calculate and report at least the effects of an interest rate shock on the market value of the institution and must be able to report the effects of changes in interest rates on the profit and loss statement. In this regard we refer to the desired freedom in general of the institutions to select the methods they use, and to the fact that the Basel Committee does not require any parallel calculation of cash value and P&L effects. A profit-and-loss-based calculation should therefore not be compulsorily required, consistent with IRRBB 1 (see our comments on paragraph 5).

Pursuant to Paragraph 21, which specifies that institutions must be able to report on the effects of instantaneous or gradual changes in the interest rates, we propose that the specified interest rate shock should be calculated equivalent to the historical simulation from the perspective of one year's duration.

Sample calculations have shown that the interest rate risk exposure can be lowered without underestimating the risk. Methodologically, this is explained by the result that the required duration of the historic simulation of one year (240 days) is transferred to the standardised interest rate shock.

- **Paragraph 23: Off-site supervision**

The requirement that additional standardised reporting formats be established for carrying out off-site supervision should be deleted. This is contrary to the basic principle of Pillar II, which focuses on the internal risk management methods and does not complement these with supervisory requirements, which are already specified in Pillar I. The internal reporting system specified in IRRBB 4 is sufficient for review purposes; complete comparability cannot be fully achieved via reports to the supervisory authorities with qualitative approaches such as Pillar II anyway.

- **IRRBB 1**

In accordance with IRRBB 1 the institutions must prove that their internal IRRBB capital is reasonable and adequate. In addition, they should be able to calculate the entire IRRBB at various consolidation levels upon request of the supervisory authorities. The requirement for an IRRBB calculation at a sub-consolidated level, for example, goes beyond the field of application of the CRD and is incomprehensible, particularly against the background of the waiver regulation granted for Pillar I. It should thus be made clear that the IRRBB must be calculable only on the basis of the scope of consolidation used by the institution within the framework of the ICAAP. Any divergence of the scope of consolidation would mean considerable additional expense, which would not be in any

reasonable proportion to the value of any additional knowledge gained by the bank supervisory authorities.

Furthermore, the idea that the supervisory authorities should be able to request the use of an "additional standardised methodology" is contrary to the basic concept of Pillar II, which focuses on internal methods. This provision, which assumes disincentives for the development by the institutions of their own methods, should therefore be deleted.

- **IRRBB 2**

The consultation paper applies the market value approach to the measurement of the interest rate risk in the banking book. In the current form, a change in market value is viewed in relation to the liable equity capital. The numerator in this case is an asset-oriented parameter and the denominator a bank regulatory parameter. It is intended to express how often an interest rate shock can be absorbed by the existing liable equity capital. This basis is inconsistent from various perspectives. For one thing, the bank actually has more potential available to cushion the effects of an interest rate shock, which is derived from the risk coverage potential to be established/calculated, than merely the liable equity capital and reserves. For another, the change in market value is an arithmetic parameter (not an accounting parameter), which is put in relation to an actual accounting parameter. We therefore propose that in the nominator, "own funds" in accordance with the ICAAP be replaced by the risk coverage potential of the bank as a logical counterpart. This aspect should be taken into account in future updates of the guideline.

- **IRRBB 4**

According to IRRBB 4, the institutions should have well-reasoned, robust and documented principles for handling all important institution-specific parameters. Subject to proportionality, this requirement refers among other things to the so-called "pipeline transactions" (Bullet Point 5) as well as the handling of implicit options (Bullet Point 9).

We suggest to rephrase the word "treatment" by "appropriate consideration" in bullet point 5, since "treatment" suggests an explicit modeling of pipeline deals. Bullet point 9 should be restricted to "interest rate movements induced positions" only (i.e. customers may repay/withdraw early due to changes in tax regulations; these execution types must be excluded from IRRBB 4).

- **IRRBB 5**

In IRRBB 5 the supervisory authorities are required to specify a standard interest rate shock to be simulated for all institutions under their supervision. The authorities can specify various shocks for different currencies. We strongly request that CEBS define only internationally harmonized interest rate shocks for foreign currencies. Otherwise every national supervisory authority will establish its own list of interest rate shocks in foreign currencies, which would place an immense burden on banks operating internationally.

Furthermore, instructions for bank supervisory authorities are also discussed in IRRBB 5. A standardised interest rate shock is described (consisting of the 1st and 99th percentile of a 5-year historical simulation of observed one-day changes in interest rates, projected for the year as a whole), which corresponds to a 200 BP interest rate shock. To be more mathematically precise, the 100th percentile in the upper right margin must be seen as the counterpart of the 1st percentile.

The approach of deriving an interest rate shift level from historical interest rate changes instead of adhering to a rigid fixed interest rate shift level is appropriate in our opinion. Furthermore, our own calculations have shown that the results of a historical simulation are currently not equivalent to a 200 BP interest rate shock. The risk is currently considerably overestimated thanks to the 200 BP interest rate shock. We propose that this postulated equivalence be discussed at an expert level in order to determine any necessary adjustments in the BP interest rate shock.

We are pleased that the supervisory authority will review at regular intervals the extent to which the figure for the standardized interest rate shock is equivalent to the results of the historical simulation. Aspects such as the length of the observation interval (5 years), the appropriateness of a parallel shift in the interest rate curve as well as the currency relation should be reviewed in this regard.

- **IRRBB 8**

In IRRBB 8 the authorities are required to understand the institutions' internal methods of determining the current market value and - insofar as this is necessary - the method of determining the share of revenue corresponding to the IRRBB, including the assumptions on which these are based. This obligation should automatically met by institutions that received regulatory approval for measuring and monitoring their market rate risk with an internal model and apply these model for market risks within the banking book.

- **IRRBB 9**

As a result of the general IRRBB assessment or the existence of an outlier criterion, the authorities should be able to implement quantitative or qualitative bank supervisory measures without delay in accordance with IRRBB 9. A possible measure could consist of requiring additional regulatory capital. It should be made clear that the IRRBB is part of the ICAAP and the SREP, and that there cannot be any additional capital requirements beyond these. We welcome the variety of methods described for responding to outlier cases; appropriate action with regard to institution-specific circumstances can be taken only if a diverse set of measures is available for this purpose.

Part 2: The concentration risk

We consider the second part of CP 11 in its present form – particularly at this point in time – to be neither necessary nor practical nor appropriate. We therefore strongly recommend "streamlining" this part of CP 11 and postponing the publication of an appropriately revised consultation paper until at least the middle of 2007. The following reasons are definitive in this regard:

From our point-of-view there is no requirement for a separate guidance paper on the issue of concentration risks: In the discussion on CP 11, it has been asserted by some that supervisory authorities and companies urgently require detailed guidance on dealing with concentration risks until Basel II goes into effect on January 1, 2007. We do not agree with this view. First of all, it was intentional that only brief specifications regarding Pillar II as a new supervisory concept were established in the CRD, in order to provide the institutions with the greatest possible flexibility in this area and to refrain from anticipating their experiences with Pillar II; we welcome this flexibility and in our opinion it is not a problem. Second, CEBS has already published comprehensive guidance on Pillar II. The second and final version of CP 03 on Pillar II already provides comprehensive guidance on the definition of Pillar II and, compared to the first version of CP 03, was even expanded to include a comprehensive chapter on the internal organisation of the banks. Based on CP 03, the German supervisory authority developed specifications with minimum requirements for risk management (MaRisk), which are appropriate and adequate - for the area of concentrations risks as well.

With a market participant survey on the internal management of concentration risks and the publication of CP 11, which includes specific provisions for handling concentration risks, being carried out concurrently, CEBS is taking the first and second steps at the same time: The questionnaire on internal bank management of concentration risks in the broader sense (including geographic, sectoral and security provider-related risks) published by CEBS on the same day as CP 11 and which served as part of the response to the call for technical advice directed by the EU Commission to CEBS should serve as the information basis for the possible further development of the EU specifications for large loans. The EU Commission must submit a report with corresponding proposals in accordance with Article 100 of the CRD not before the end of 2007.

In principle we approve of the Commission initially asking market participants about their assessment of the specifications regarding large loans and their internal management of concentration risks. However, we consider the period in which this dialogue with the market participants is to take place too short. For a complex issue such as concentration risks, the consultation cannot be limited to a single survey, but instead must take the form of an interactive dialogue. In view of the current burden on the banks posed by the IRBA and AMA audits as well as all the rest of the CRD realizations, resources for such a dialogue in an appropriate scope will not be available until 2007.

While the CEBS questionnaire includes a basis for possible future rules, such rules are already established in CP 11. In CP 11 it is even explicitly stated that supplements and

changes would have to be made to CP 11 depending on the result of the CEBS survey. The premature establishment of rules in CP 11 clearly thwarts the purpose of the CEBS survey carried out on behalf of the Commission. The institutions are not only required to shoulder the burden of responding to the questionnaire, the analysis of which will possibly have no effect whatsoever on future rules, but there is also the danger that the specifications of CP 11 will ignore entirely the proven practice of the institutions with regard to concentration risks.

The second part of CP 11 Part 2 should therefore be postponed until the CEBS survey of internal management of concentration risks, including the discussion with the market participants, has been completed and above all until a sufficient degree of auditing experience exists with regard to Pillar II. In this context we wish to note two points in conjunction with the questionnaire. First, the published form of the questionnaire is far too detailed in our opinion. Furthermore, the analysis of the survey results must not lead to a situation in which the respectively highest standards of the institutions participating in the responses to the survey are declared without reflection to be binding best practice for the entire European banking industry, thus destroying the principle of (doubled) proportionality, i.e. the orientation of processes to the object, size and complexity of the transactions of the individual banking institution.

The specifications in CP 11 regarding the management of concentration risks go significantly beyond the CRD. The fact that CP 11 goes significantly further than the CRD will most likely be very alarming for smaller or very specialised institutions (e.g. special group companies) in particular. It would be necessary to review the extent to which the requirements of CP 11 are still within the range of legal interpretation or whether they are not already a form of legislation. Thus in CP 11, CEBS refers primarily to the corresponding recommendations of the Basel Committee on concentration risks; these, and only these, are contained in the appendix to CP 11, even though they are merely recommendations and are directed only to internationally operating banks. The text of the CRD (Article 123 and Appendix V, No. 5), which forms the sole legal basis for the work of CEBS - and which is not included in the appendix to CP 11 - contains only brief specifications with regard to concentration risks and requires only that concentration risks be addressed and managed by means of written regulations and procedures. Article 110, Paragraph 3 also shows that the specifications of CP 11 go beyond those of the CRD. These explicitly give the member states the right to choose whether to impose the recording of concentration risks with regard to the guarantors. The specifications of CP 11 contradict this right to choose.

Regardless of the time of presentation of CP 11 (see above), we therefore believe that a significant streamlining of the paper is required to ensure congruence between CRD and CP 11.

CP 11 will lead to restrictions on internal models: CP 11 attempts to follow general principles, but still lists relatively detailed specifications. This imposes restrictions on the institutions which are not necessarily comprehensible as such. The goal must be to create a set of principles that guarantee a certain quality standard, yet allow the institutions sufficient flexibility and freedom of action. However, we believe that detailed analysis

and evaluation of these issues are necessary, which requires in particular initial practical auditing experience in the area of Pillar II.

CP 11 focuses entirely on the concentration of risks and the measures to be taken in such cases (including, depending on the circumstances, additional internal capital requirements believed to be necessary). On the other hand, the opportunities arising from the diversification of risks, which must lead to corresponding capital benefits, are not sufficiently addressed; the additional effort and expense incurred for more intensive/improved risk recording must also be accompanied in the relevant cases by easing the pressure on the capital ratio and it must be recognised that in diversified portfolios a lower level of monitoring with regard to the concentration risks is necessary and justifiable. This is not only realistic and appropriate, but also corresponds to the principle of providing incentives to transition to more advanced methods of risk management.

We are always available for further discussions.

Best regards,

on behalf of the

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p.p.



(Bernhard Krob)