German Banking Industry Committee

Die Deutsche Kreditwirtschaft

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European Banking Authority

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EBA Consultation Paper on Draft Regulatory Technical Standards on the specification of specific and general credit risk adjustments according to Article 105(4) of the draft Capital Requirements Regulation (EBA/CP/2012/10)

Dear Sir or Madam,

We would like to thank you for the opportunity to comment on the Consultation Paper published on 17 July 2012 concerning "Draft Regulatory Technical Standards on the specification of specific and general credit risk adjustments according to Article 105(4) of the draft Capital Requirements Regulation (EBA/CP/2012/10)". We appreciate this opportunity. Please find our comments below.

Introduction

We generally welcome the fact that the requirements of this RTS for the calculation of the specific and general credit risk adjustments are of a very generic nature. This may help to ensure an adequate reflection of the various accounting standards. We wholeheartedly subscribe to the objective of shaping the RTS requirements with a view to them being largely independent of the respectively applicable accounting framework.

Concerning IFRS users, for quite some time now a transition from the so-called "incurred loss model" to the more forward-looking so-called "expected loss model" is being discussed. In this context it is evident that during such a transition both at the level of the Capital Requirements Regulation (CRR) and also at the level of the present RTS draft there will be a need for significant and complex adjustments, for instance in the

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field of the forthcoming value adjustment subtraction [as defined under Article 155 CRR]. In this context, we hope for an early involvement of the European banking industry during the respective discussion rounds and gladly offer our assistance as regards this challenging task of finding the right approach.

Furthermore, the specific approach to be adopted with regard to the treatment of expected loss amounts [as defined under Article 155 CRR] remains unclear. This lack of clarity is due to the fact that pursuant to Article 155, sentence 3 CRR, specific credit risk adjustments for defaulted exposuresmay not be used in order to cover other expected loan losses. In our view, this renders a uniform treatment of expected loss amounts [as defined under Article 155 CRR] impossible. We therefore suggest adopting the following approach:
First of all, there needs to be a juxtaposition of the expected loss amounts for all defaulted exposures and the specific credit risk adjustments related to these exposures (first part of the treatment of expected loss amounts [cf. Article 155, sentence 3 CRR]). If there is a surplus at this point, said surplus cannot be used in order to cover the expected losses of non-defaulted loans; pursuant to Article 59 (d) CRR, however, this surplus may be recognised as Tier 2 capital. If there is a shortfall, this shortfall will be factored into the overall treatment of expected loss amounts.

Subsequently, the expected loss amounts of the non-defaulted exposures are to be juxtaposed with the specific credit risk adjustments related to these exposures and the aggregate amount of the general credit risk adjustments for the aggregate amount of exposures. Together with a potential shortfall from the first part this second part treatment of expected loss amounts would constitute the overall value adjustment comparison.

Said approach should be laid down as binding under the RTS (or under another official pronouncement).

Specific comments on individual articles:

Article 2 (1)

Consideration during the current fiscal year
In the EBA's view, credit risk adjustments should be eligible for recognition if, first, they reduced the bank's Core Tier 1 and second, if they reflect losses exclusively related to credit risk according to the applicable accounting framework (Article 2 (1) RTS). Whilst, essentially, this appears appropriate, from our point of view two clarifications are necessary. First, in our understanding the terminology "credit risk" is geared towards the eponymous provisions under the CRR. Hence, write downs or value adjustments for items established based on Part 3 Title II "Capital Requirements for credit risk" of the CRR would be covered by the regulatory scope of the RTS. Second, we would appreciate a clarification that a reduction of a bank's Core Tier 1 within the meaning of said requirement already exists if the credit risk adjustments appear as expenditure in the bank's profit and loss statement. An equivalent loss amount posted shall and must not be an eligibility criterion for recognition. This is due to the fact that otherwise profitable banks would be penalised given that they would only be eligible for recognition of a lower amount of credit risk adjustments.

What is of major importance in this context is the recognition of value adjustments which have already been created but which have not yet entered the profit and loss statement (of the financial statement). In our view, it should be possible to also take those value adjustments into account. This is due to the fact that otherwise there would be a discrimination of banks which do not draw up any quarterly reports. Said value adjustments are taken into account during the determination of the banks' current losses which banks have to deduct from Core Tier 1 pursuant to the provisions of Article 33 (1)(a) CRR. There should be a clarification that including these items during the determination of the current losses shall be deemed sufficient for the purposes of recognition as credit risk adjustment. Similarly, at this juncture a loss to the same amount for the current financial year shall and must not be an eligibility criterion for the recognition. Otherwise this would penalise profitable banks.

Treatment of expected loss amounts *[as defined under Article 155 CRR]*
Furthermore, we would like to point out that, in its general approach on the CRR made on 15 May 2012, Council of the European Union also suggests including in the treatment of expected loss amounts [as defined under Article 155 CRR] additional other value adjustments [as defined under Article 31 and 105 CRR] along with general and specific credit risk adjustments. The Council also suggests including further adjustments that reduced banks' own funds. We explicitly support this proposal. This shall also cover value adjustments within the meaning of Article 100 CRR provided that they were created for items of the banking book measured at fair value. In our view, it should be possible to include these adjustments into the treatment of expected loss amounts [as defined under Article 155 CRR].

Inclusion of negative revaluation reserves
In order to reflect losses from AfS assets, in the event of a CET1 reduction due to a negative revaluation reserve, in our understanding a corresponding amount can be factored into the calculation of the GCRA's and SCRA's (provided said amount resulted from credit risk related losses). This amount corresponds to the sum which needs to be deducted from CET1 according to the CRR's grandfathering rules. Along with the AfS assets, it should be possible to include into the calculation of the GCRAs and the SCRAs also any other negative changes of fair valued positions (provided they are credit risk related).
Isolating credit related effects from other market related effects constitutes a major challenge and is not always feasible. From our point of view, three options would be possible:

1. Complete recognition of the reserve in the exposure value and treatment of expected loss amounts [as defined under Article 155 CRR].
2. Similar to option 1 but the amount shall be limited to the expected loss (EL) of an individual exposure or of a group of exposures.
3. If and when singling out the interest rate related effect of the value adjustment for interest products and its allocation to an exposure is possible, the remaining amount shall be defined as a form of SCRA.

We prefer option 3 as the most likely form for an appropriate consideration of corresponding losses. Regardless of the aforementioned alternatives we would like to suggest the following clarification: Should a reserve or parts thereof not qualify for categorisation as SCRA then it will neither be necessary to ascribe the reserve to the carrying amount of the exposure nor is it necessary to take it into account during the treatment of expected loss amounts [as defined under Article 155 CRR].

Dynamic versus static view

It does not become clear from the Consultation Paper whether the CP refers to value discounts which have been posted and audited / approved

- during the current financial year as per the respective reporting date under the bank's applicable accounting framework (dynamic view) or
- whether this deduction was made during the last annual financial statements / interim accounts (static view)

In this context a question arises: In Germany, at least to date, there is a distinction between dynamic and static own funds elements (which is especially relevant for the result of the treatment of expected loss amounts [as defined under Article 155 CRR] and the deductable item for intangible assets) and there is the static treatment of value adjustments / write downs. It is unclear, whether this regime will remain in effect or whether a consistent dynamisation in this area will be requested under the provisions of the CRR. In our view, the latter approach would make sense given that pursuant to Article 33 (1)(a) CRR the losses for the current financial year have to be deducted directly from CET1. Furthermore, this would result in a clear reduction of the complexity as well as higher consistency of the various reporting data (especially solvency data compared to P&L as well as risk data).

Article 2 (2), (3) and 5

According to explanations accompanying Article (2) ("Text for consultation purposes") the Article 2 criteria are drafted in a way that they can be applied irrespective of the accounting framework. The explanation of paragraph 5 for SCRA und items (b) and (c) refers to the so-called incurred loss model for IFRS users. Also, under Article 2 (b) there is only reference to GCRA if banks have <u>no reason</u> to believe that a loss event has occurred.
On the other hand, IAS 39 (59) makes the following statement for IFRS users: "Losses expected as a result of future events, no matter how likely, are not recognised." Hence, in our understanding, when using this incurred loss model under IFRS, value adjustments made on the basis of IFRS can only be SCRA and not GDCRA. We would like to suggest clarifying this.

In our view, the value adjustments within the meaning of Article 37 (2) of Directive 86/635/EEC (in Germany hidden provision reserve which is taxed within the meaning of Section 340f German Commercial Code) are in linewith the definition of general credit risk adjustments (GCRA) within the meaning of Article 2 (2) of the RTS. Such value adjustments are exclusively made under due reference to items which involve credit risks. Hence, they correspond to the requirements under Article 2 (1) pursuant to which they must be created in order to reflect "losses exclusively related to credit risk". Furthermore, it is our understanding such value adjustments can be included in the treatment of expected loss amounts[as defined under Article 155 CRR] pursuant to Article 155 CRR-D. We would like to suggest clarifying these points.

Article 3

The article explains the process necessary for banks using the standardised approach for credit risk pursuant to which SCRAs which were created for a group of exposures shall be assigned to the single exposures (cf. page 20, policy option No. 3). The SCRA should be assigned to single exposures of the group proportionally to the risk-weighted exposure amounts. Said process is fairly complex. More simple approaches should not be barred. It is not necessary to force banks to use a unifiedmethodology. The SCRA created at this juncture have already reduced the liable capital. This corresponds to a risk weight of 1250%. Even if the banks were to allocate the SCRAs completely to the risk weight category with the highest risk weight, this would not be an issue due to the preceding 1250% weighting. We therefore advocate in favour of leaving to the institutions the decision of how to assign portions of the amount resulting from SCRAs to the exposures in the group (policy option number 2). Notwithstanding the foregoing, this does not prejudice the eligibility of option 3, either.

Article 6

Under the provisions of Article 6, only those value adjustments will have to be taken into account the creation of which is due to a significant deterioration of the credit quality on an individual basis, i.e. a default that has been noted on an individual basis. A value adjustment which was created on a general basis for a group of exposures thus does not constitute a sufficient criterion for categorisation of an event of default. However, it is a common practice for individual banks to make these value adjustments directly at the level of the individual exposures (e.g. PD based) and not only at portfolio level. In our understanding, said value adjustments must equally not be regarded as leading to an event of default. This is already owed to the fact that in such cases there will not be any significant deterioration of credit quality. We therefore suggest a corresponding clarification.
We would appreciate it if our comments were taken into account during the forthcoming consultation process. Please feel free to contact us for further information or any queries.

Yours sincerely,
on behalf of the German Banking Industry Committee
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