Sparkasse
Aachen

A petition for more proportionality in the supervisory process

EBA Workshop
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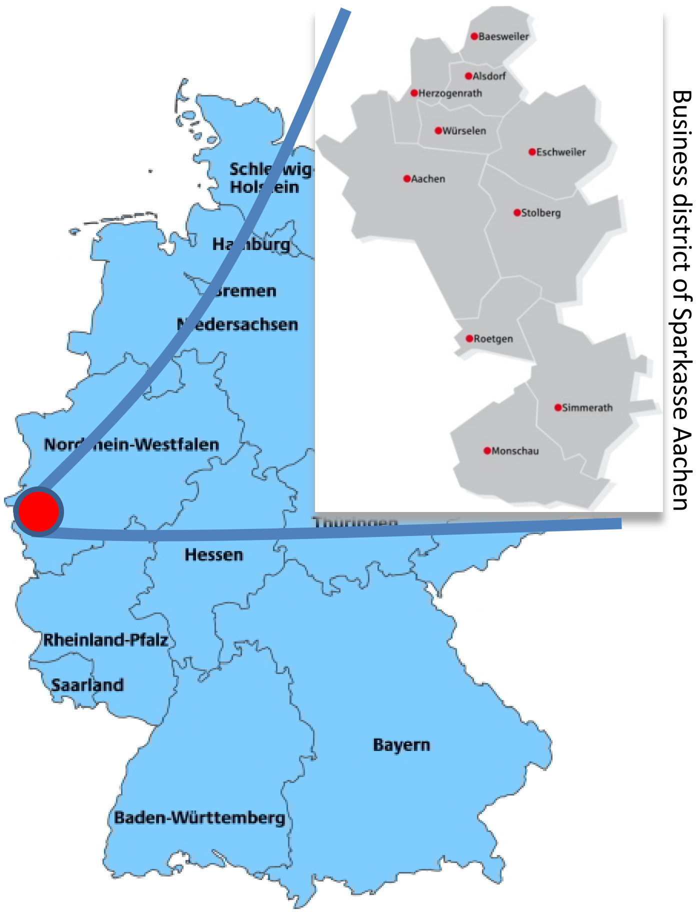
Sparkasse Aachen is a highly capitalised mid-sized savings bank in the most western part of Germany.



Key figures (as of year end 2014)

▪ Founded in	1834
▪ Balance sheet	10.0 bn €
▪ Tier 1 equity	1.1 bn €
▪ Solvency ratio	21.8 %
▪ LCR	1.19 (April 2015)
▪ Leverage ratio	8.57
▪ EBT*	131.5 m €
▪ Credit and market risk provisions	+12m € (i. e. net release)
▪ Employees	1,544 (full-time equivalents)

- Two business units

	Private clients	Corporate clients
Customers	285,112	28,185
Market share**	58 %	67 %

* Before provisons for para. 340 g HGB (32,3 m €)
** Region of greater Aachen, 500 k people

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Sparkasse Aachen runs a bespoke business model (1)

1

We know our customers *

- Due to the focus on the local area of greater Aachen, all risk-relevant customers are personally known as we run circa 100 branches.
- Knowledge of individual borrower characteristics
- Servicing local business and private clients

2

Highly granular credit portfolio

Size of loan per debtor	% of overall portfolio
≤ 0.5 k€	47
≤ 5 m€	70
≤ 20 m€	80
max. self-restricted size of single debtor:	119 m€ **

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* Compensates the idiosyncratic risk of doing business locally
** Large exposure maximum size 298 m€

Sparkasse Aachen runs a bespoke business model (2)

3

Funds stem from own customers only

- No funding necessary from third banks due to the business model

Assets		Liabilities	
Loan book	7.1 bn	Deposits	7.5 bn
		Equity*	1.2 bn

* Tier 1 plus tier 2

4

Risk mitigating techniques

- Fixed term loans up to 15 years
- Typically no non-recourse project finance
- 50 % of the overall loan book is secured by residential property charges
- Real estate typically financed only up to 80 % loan-to-value
- Annuity of 6 % generally required for all residential property financing
- Debt service coverage is mandatory for all loans
- No proprietary trading activities

The current and envisaged regulation is burdensome

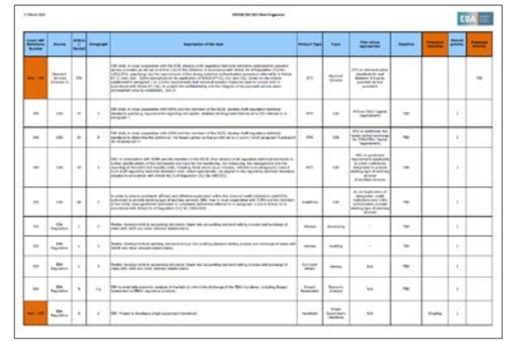
- The idea of greater European integration is welcomed, and thus the European Banking Union is a consequent step forward.
- Having said that, ECB and EBA should be aware of
  - Multiple regulations from local governments, domestic regulators and BCBS, ECB, and EBA
  - A very limited time horizon for implementation
  - A lack of fully harmonised regulation by all bodies
  - Ongoing changes of technical standards until the due date (“moving target”)*
  - Expenses for the implementation are immense at a time when banks are stressed by QE and the low interest rate.
- The limited size of regional and savings banks makes it ambitious to amortize the fixed costs of being compliant with the regulation
  - Small banks may be forced to cease operations, thus reducing their local services
  - Large banks are not willing to fill the gap as small communities and clients are not their target group

* e.g. ITS on leverage ratio again amended on 15 June 2015

The EBA work programme 2015 indicates the effort of implementation each Sparkasse faces

55 pages

454 items



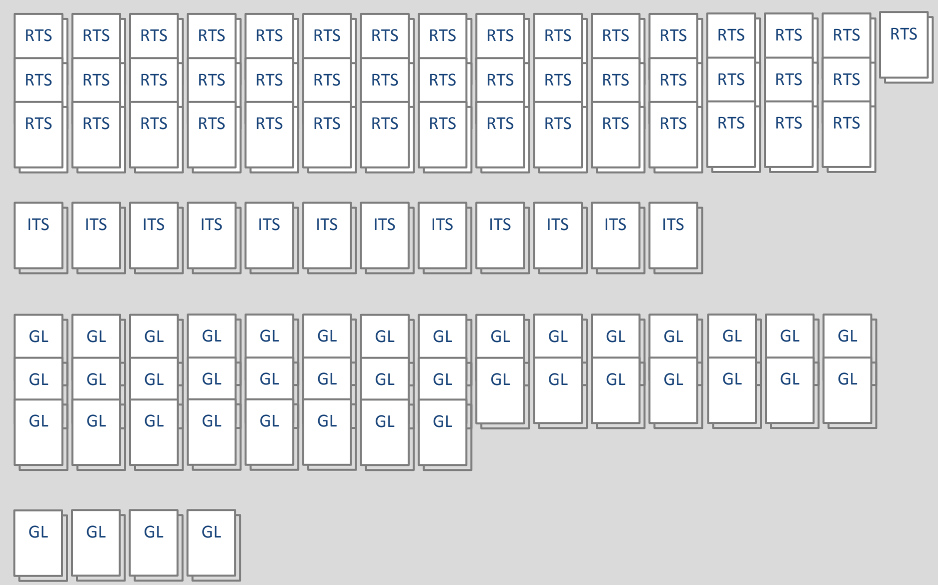
including:

46 Regulatory Technical Standards

12 Implementing Technical Standards

38 Guidelines (with explicit mandates)

4 Guidelines (own EBA initiatives)



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Source: DSGV, Berlin

Regulation tends to distort structural evolution

The right to run one's business without having to face discrimination must be accepted. If all requirements are enforced regardless of how simple and risk free a business model is, the fixed costs of the regulation will amount to an untenable sum (in relative terms):

Requirements

- All regulatory documents must be checked even when only partially relevant
- Huge investments into IT software and hardware will become necessary

Consequences

- Tendency to larger, complex entities
- Fewer banks, therefore less diversified financial industry
- Riskier structures evolve

Regulation must not initiate structural changes in the economy

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A proportionate approach is necessary

- Required steps are

1 Reduce the pace of regulation

2 Harmonise the approach of all regulatory bodies and cancel duplicated domestic reports and controls

3 A freeze of require-ments once defined, i. e. amendments and changes only in co-ordinated intervals

Business model matters

- Smaller banks didn’t cause the financial crisis
- Savings banks typically run a very granular portfolio, which is very resistant to industry disruptions
- For Sparkassen and regional banks the “too-big-to-fail” problem doesn’t exist

The business model of a Sparkasse justifies a proportional approach of regulation und supervision (I)

Example 1: Mortgage Credit Directive (MCD)

EBA summary:
“Consumers are to be protected consistently across the EU member states with specific focus on residential immovable property including creditworthiness assessments, arrears, and foreclosure.”

- Verification of information
- Reasonable debt service coverage, lending thresholds, debt-to-income ratios
- Appropriate loan-to-value ratios
- Lending and supervisory process

Proportionality required:
An efficient “light” process without too many checks for small amounts (tbd) is appropriate, if debt service coverage is given.
Example:

- Free debt service of 2 k€ per month
- 50 k€ loan for refurbishment should be acceptable (annuity of 333 € pm @ 8 %)

Reasoning:

- Market is very competitive, thus efficient processes are needed.
- Portfolios are highly granular and thus do not have a severe impact on a bank.

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The business model of a Sparkasse justifies a proportional approach of regulation und supervision (II)

Example 2: SREP

EBA SREP: „The key purpose of SREP is to ensure that institutions have adequate arrangements, strategies, processes and mechanisms as well as capital and liquidity to ensure a sound management and coverage of their risks, …“ (website EBA) • Four categories according to complexity and risk • Assessment of business model, internal governance and institution-wide controls, ICAAP and ILAAP • Supervisory measure (capital, liquidity, supervision)	Proportionality required: • Categorisation welcomed if relief from regulation is granted • Supervisors should be entitled to scale down SREP GL according to size and risk (proportionality not limited to frequency of reporting) • Pillar 1+ approach leaves less room for proportionality than pillar 2

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The business model of a Sparkasse justifies a proportional approach of regulation und supervision (III)

Example 3: Finrep

EBA and ECB: Implementation of technical standards on supervisory reporting - requirements for smaller banks	Proportionality required:
• Sparkasse Aachen qualifies for "*over-simplified reporting*" • Reporting of data which are (allegedly) already used for accounting • Based on IFRS figures, but not in any case identical • Finrep consolidation is different from the one of accounting	• Only the biggest banks in Germany use IFRS (circa 25) • The majority of 1,000+ banks stick to the German GAAP (HGB, which is based on the principle of protection of creditors rather than IFRS capital market view). • HGB runs a different methodology and balance sheet structure, thus Finrep figures are not readily available • Consolidation is different • HGB banks would be forced to implement a kind of an "IFRS shadow accounting", causing huge investments

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A Sparkasse shouldn't be affected by the additional regulation of shadow banks.

Example 4: Shadow Banks (SB)

EBA CP "Draft EBA guidelines on limits on exposures to shadow banking entities …" • Regulation of shadow banks and transparency are welcomed to achieve a level playing field with banks • Very broad definition of SB, including factoring and leasing corporations, UCITS and AIF managers • Regulation intends to set strict, additional limits for lending to SB	Changes are requested: • If necessary, **SB** (rather than banks) should be monitored more closely, and tighter regulations be implemented – additional burden on banks is not justified • Portfolio limits and individual limits per counterparty already sufficiently regulated by CRD / CRR and SREP • To manage liquidity, Sparkassen make outright investments in bespoke funds which fully comply with **AIF** or **UCITS** regulations • In Germany, **factoring** and **leasing** businesses * are nearly as well regulated as banks and needed for the business to provide customers with the full range of financing. → vehicles should be removed from the list of SB

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* some being owned by Sparkassen; look-through principle in place.

A proposal for a smart regulation and supervision

Given the locally focussed business model of savings banks,

- A two tier approach of regulation should be considered *

Instead of lumping together all kinds of banks and defining minimal requirements, regulators should develop bespoke methods for the various classes of banks.

1 Highly interconnected international banks with complex structures and products plus proprietary trading

Internationally harmonised approach to avoid competitive disadvantages

2 Local plain-vanilla-banking ("community banking")

Why not agree on a simpler supervision with clearly defined exemptions?

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* As being implemented in the USA. The two tier US regulation can be seen as a blueprint (D. K. Tarullo: Tailoring Community Bank Regulation and Supervision, April 2015)

Conclusion

Proportionality matters because -

- Across Germany, all Sparkassen are a kind of a highly diversified portfolio of banks, thus posing less risk to the taxpayer, than countries and economies with a highly integrated bank industry
- Local banks are not interconnected with international capital markets, therefore no spill-over effect likely in case of any market turbulence
- Only plain-vanilla businesses and products with local customers on the balance sheet (deposits and loans)
- A two-tier-regulation is most welcomed