Bundesverband der Deutschen Volksbanken und Raiffeisenbanken e. V.
Bundesverband deutscher Banken e. V.
Bundesverband Öffentlicher Banken Deutschlands e. V.
Deutscher Sparkassen- und Giroverband e. V.
Verband deutscher Pfandbriefbanken e. V.

Die Deutsche
Kreditwirtschaft

Comments

on the EBA Consultation Paper

"Draft Guidelines on methods for calculating contributions to Deposit Guarantee Schemes"

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EC Register of Interest Representatives
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The German Banking Industry Committee is the joint committee established by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks; the Bundesverband deutscher Banken (BdB), for the private commercial banks; the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks; the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group; and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

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Questions related to the draft Guidelines

Q1 Do you have any general comments on the draft Guidelines on methods for calculating contributions to DGSs?

The German Banking Industry Committee (GBIC) would like to start by expressly welcoming the fact that the European standards will require all deposit guarantee schemes to collect their contributions in the form of ex ante payments and that the contributions themselves will have to be risk-based. This implements at the European level the established practice in Germany for many years, which ensures that the contributions collected are sufficient and which supports financial stability, all the while enhancing the level of protection offered to depositors.

We also welcome the general structure and organisation of the Consultation Paper, from which it is clear that the June 2014 results of the EFDI Working Group on "Risk-based Contributions" (which are also supported by the German Banking Industry Committee) have also been addressed. This has seen certain fundamental principles based on the CAMELS approach and practical experience from the work of established guarantee schemes, among other things, being incorporated into the EBA draft Guidelines from the outset.

From GBIC's perspective, however, it is particularly important to draw attention to some critical points:

- The draft Guidelines contradict the will of the European Parliament, as expressed by Article 13(2) of the DGSD, that well-established methods of determining and calculating risk-based contributions that have been used by deposit guarantee schemes for many years should be acknowledged as equivalent, and should also be permitted to be used without any future restrictions. The deposit protection schemes to which the members of the German Banking Industry Committee belong have their own, tried-and-tested risk-based systems that are used not only to determine individual contributions, but also serve preventive purposes.
- In general, GBIC considers the draft Guidelines to be insufficiently risk-sensitive. Article 13 (2) DGS Directive (2014/49/EU) expressly allows for the use of own risk-based methods for the determination and calculation of risk-based contributions, as long as these methods appropriately account for the risks posed by their members (as is the case for the institutional protection schemes and additional voluntary schemes employed in Germany). In this respect, the DGS Directive requires the corresponding EBA Guidelines to allow for the use of own risk-based methods in order to avoid moral hazard and to not impair the quality of existing protection schemes across the European Union.
- It is understood that the use of appropriate own methods does not in any way affect the DGS Directive's funding requirements or the final target level for an individual DGS overall.
- Taking the legislative process into consideration there is no basis for a maximum-harmonisation approach in this area of banking regulation. This is apparent from the DGS Directive's text as well as from the corresponding readings that took place in the European Parliament (see below).

- Furthermore, both individual DGS and Institutional Protection Schemes (IPS) are required to be approved by the competent authorities. This by itself ensures high levels of quality and harmonisation across Member States.
- At the same time, the concepts that underlie the Guidelines give the impression that such systems will now have to be subordinated to an approach defined by the EBA that, from GBIC's perspective, is unfortunately insufficiently grounded and has not been empirically validated. We therefore have substantial concerns about the Guidelines.
- The formula chosen by the EBA for calculating the contributions is based pre-dominantly on each institution's covered deposits (which are then subjected to additional weighting factors which will not be addressed here). However, focusing exclusively on an institution's deposits does not allow sufficient scope, in particular for the guarantee schemes that have functioned successfully in Germany for many decades, for reflecting institution-specific risk and hence for risk prevention. In the course of the consultation processes in the run-up to the vote in the European Parliament, the representatives of the German Banking Industry Committee stressed repeatedly that it is not a bank's covered deposits, but invariably its risk-weighted assets, that represent the systemic risk in the case of institutional protection schemes. Unfortunately this argument, which was accepted universally by the Parliament's representatives, is not sufficiently reflected in the present Guidelines.
- Most crucially, the use of the amount of risk-weighted assets for the determination of DGS contributions implies a significantly higher risk-orientation that should not be abandoned by the Guidelines.

Q2 Do you consider the level of detail of these draft Guidelines to be appropriate?

Following the basic concept underlying the Guidelines – which are not designed to have the same level of detail as Regulatory Technical Standards – we are not entirely satisfied with the level of detail of the Guidelines, among other things in light of the lack of any statistical, historical data basis for the risk indicators and the weighting factors. Rather, we think it would be appropriate to treat these Guidelines simply as guidance, and for the relevant deposit guarantee scheme to continue to be responsible for the detailed design of a model based on the parameters proposed in the Guidelines. In this respect, further increasing the level of detail of the EBA's proposals would make the methodology considerably more specific, which is something the German Banking Industry Committee would not support.

Q3 Is the proposed formula for calculating contributions to DGS sufficiently clear and transparent?

In principle, the calculation formula contains those components for deposit guarantee schemes that appear to be necessary to allow appropriate contributions to be calculated.

However, it most certainly needs to be mentioned at this point that basing the risk calculation for deposit guarantee schemes that are organised in the form of an institutional guarantee scheme solely on covered deposits will result in potential misallocations. The alignment of individual risk-

based contributions to risk-weighted assets and a greater flexibility in calculating the assumed risk parameters would be necessary preconditions to avoid this. In this context, we would also like to draw attention to the fact that the 75:25 distribution factor for the core risk indicators and additional risk indicators is definitely too rigid. Numerous contributions at the EBA's hearing on 8 January 2015 demonstrated that it is not just the German deposit guarantee schemes demanding greater flexibility in this issue. We consider a ratio of 50:50, or possibly 60:40, between the two categories to be appropriate.

We also wish to point out that the risks affecting the credit institution (core risk indicators 1 to 4) are intermixed with the risks affecting the deposit guarantee scheme (core risk indicator 5, Potential losses for the DGS) with the term ARW_i in the formula. This dilution could weaken the incentive effect which is necessary to avoid moral hazard. A sharper distinction methodologically in the formula – and consequently in the contribution assessment – between contribution effects resulting from institution-based risks and those from funding risks should therefore be considered.

We especially welcome the factor μ (in the calculation formula on page 14, no. 34) as an element of flexibility, however the factor μ (adjustment coefficient) in its function to avoid excessive contribution during economic downturns, and to allow faster build-up of the DGS fund in economic upturns, is not clear in its practical implementation. How is an economic downturn or upturn defined? How is a business cycle adjustment compatible with reaching the target level as economic downturns normally last longer than a year? Does the term business cycle means the economic cycle of the whole economy in one country, a region, or overall in Europe, or does it mean the business cycle of the banking industry (again: in one sector, one country, a region, or overall in Europe). It remains unclear who is expected to decide whether the use of μ is adequate and on the basis of which arguments this is to be evaluated. One has to consider that the business cycles of the banking industry is lagging behind the economic cycle. Furthermore the lagging effects are individual with regard to business models (different time-lags). It has to be avoided that the factor μ might be misused to postpone the burden of paying contributions to future periods. This will potentially create a so-called "hockey stick effect" with a very high "balloon rate" on the end of the 10-year-build-up-period for the fund.

In addition we would like to point to a potentially dramatic implication of the draft Guidelines' calculation formula. Since the formula does not contain any prognostic elements, it does not adequately account for failure events or return flows during the build-up period. A failure event in year 8 or 9 of the build-up period with a pay-out that diminishes the financial means of the fund almost completely (but not in the volume of 0.8% of covered deposits), would create the need to replenish almost all of the target level by regular contributions alone within the remaining one or two years. We have serious concern that this could lead to strong pro-cyclical effects.

Q4 Considering the need for sufficient risk differentiation and consistency across the EU, do you agree on the minimum risk interval (75%-150%) proposed in these Guidelines?

We believe that this interval is sufficient in principle. The Guidelines also allow for the possibility of extending the range to 50–200%, and permit an even wider interval in specific cases.

However, we wish to qualify our agreement with regard to institutional protection schemes, where exhausting higher risk weighting factors for individual risk indicators will not lead to the necessary differentiation in contribution levels. To underline the effects, one of GBIC's member associations has drafted a model on basis of the draft Guidelines, which clearly shows the adverse risk-indications and the intrinsic moral hazard risk; the most significant examples show a reduction of the annual contribution for more than 99 %(!) of banks with low amounts of covered deposits but high amounts of risk-weighted assets; these effects not only apply to central banks but to other entities as well. At the same time, the sample showed contribution increases of more than 400 %(!) annually although the respective amounts of risk-weighted assets are comparatively low. The problems associated with measuring contributions in institutional protection schemes cannot be solved via risk differentiation. The only appropriate approach here is to change the measurement base and thus to move away from covered deposits and towards risk-weighted assets.

At a minimum, a clarification should be incorporated into the Guidelines explaining that minimum contributions can also optionally be defined using risk-based methods, and that the asset side of the balance sheet and risk-weighted assets can also be taken into account in accordance with Article 13(2) of the DGSD.

Q5 Do you agree with the core risk indicators proposed in these Guidelines? If not, please specify your reasons and suggest alternative indicators that can be applied to institutions in all Member States. Do you foresee any unintended consequences that could stem from the suggested indicators?

In the opinion of the German Banking Industry Committee, the binding core risk indicators presented in tables 1 and 2 are too heavily focused on purely balance sheet ratios. These indicators appear to be relatively easy to obtain because they consist of generally accepted, familiar ratios, and can even be taken in large part from the supervisory reporting. However, the experience of the banking associations that work together in the German Banking Industry Committee is that ratios based on profit or loss measures have proven to be considerably more effective in risk modelling practice for deriving information about a bank's risk exposure at an early stage. Unfortunately, only 6.5% of the weights proposed in the Guidelines relate to a measure of profit or loss. Despite the additional risk indicators described in the Guidelines, it is the experience of the GBIC that a model developed on the basis of these Guidelines would probably remain too strongly focused on balance sheet data, in particular because 75% of the weights used for these core risk indicators are substantially balance sheet-based. The consequence is that it is unlikely that a model with a high level of statistical predictive power can be developed on this basis.

The concerns are further aggravated by the fact that the following three core risk indicators seem to be significantly correlated:

Leverage ratio (1.1.) $\frac{Tier\ 1\ Capital}{Total\ Assets}$

Common Equity Tier 1 ratio (CET 1 ratio) (1.3.) $\frac{CET\ 1\ ratio}{Risk\ Weighted\ Assets}$

Risk Weighted Assets (RWA)/Total Assets ratio (4.1.) $\frac{Risk\ Weighted\ Assets}{Total\ Assets}$

This results in an overreliance on risk-weighted assets and total assets respectively.

In light of this, the German Banking Industry Committee is calling for the inclusion of an enabling clause that will allow deposit guarantee schemes to continue using their tried-and-tested systems for risk-based contribution collection. The schemes could demonstrate the effectiveness of their systems or could be required to do so. Additionally, Article 13 (2) DGSD stipulates that the competent authority shall analyse and approve each method; this ensures a harmonised implementation in accordance with DGSD and the EBA Guidelines. It goes without saying that these deposit guarantee schemes will also be required to reach the target level of 0.8% of covered deposits by the date stipulated in the DGSD.

Considering the overreliance and high correlation mentioned above, GBIC recommends to replace the ratio "4.1 Risk weighted asset/total assets" within "4. Business model and Management" of the core risk indicators by additional risk indicators especially the qualitative assessment of the quality of management and internal governance arrangements, and as far the additional risk indicators consider the institution´s ability to generate profits to replace ratio "4.2 Return on Assets" as well. Besides opening of the Guidelines for experienced approaches such an amendment would lead to a higher risk orientation and mitigation of moral hazard and would be a first step towards higher flexibility and a stronger focus to essential risk categories like the quality of management and internal governance arrangements.

Q6 Do you agree with the option to use either capital coverage ratio or Common Equity Tier 1 ratio as a measure of capital? Would you favour one of these indicators rather than the other, and why?

The German Banking Industry Committee favours CET1 because it is a ratio used in supervisory reporting that is very widespread and accepted, and the banks are already strongly oriented on this ratio.

However, it is also worth mentioning that, if the banking supervisors exert a stronger influence on the specific characteristics of this ratio in future, this might conflict with prudential requirements (e.g. a relatively low ratio accepted by the supervisors) and might result in a higher risk-based contribution because of a relatively low ratio.

Q7 Are there any particular types of institutions for which the core risk indicators specified in these Guidelines are not available due to the legal characteristics or supervisory regime of these institutions? Please describe the reasons why these core indicators are not available.

As the core risk indicators are generally accepted indicators that are also already embedded in binding prudential directives, the availability of these indicators should be possible for the vast majority of institutions in the medium term. However, the indicators relating to the calculation of liquidity ratios do not yet appear to be at a stage where universal availability can be guaranteed.

Q8 Do you think that more guidance, or specific thresholds, should be provided in these Guidelines with regard to calibration of buckets for risk indicators, or minimum and maximum values for a sliding scale approach?

Considering that EBA is mandated to issue Guidelines in this case, GBIC is not of the opinion that further far-reaching specifications are needed as could be the case with binding regulatory or implementing technical standards. The experience of GBIC shows that the bucket approach is usually sufficient, although more sophisticated systems with greater practical experience tend towards using sliding-scale approaches.

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