Deutsches Aktieninstitut

Impact of the Prohibition of or Constraints on the Use of Internal Model Approaches on Non-Financial Companies Should Be Evaluated Carefully

Concerns on potential discrimination against highly solvent non-financial companies

Position Paper of Deutsches Aktieninstitut on the Basel Committee on Banking Regulation Consultative Document "Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches", 21 December 2016

This position paper briefly summarizes the comments of German non-financial companies on the consultation paper "Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches" issued by the Basel Committee on Banking Supervision (BCBS) in March 2016. Our view is based on discussions in the corporate finance/corporate treasury working group of Deutsches Aktieninstitut which is the central forum of opinion building for the treasury departments of the largest German non-financial companies, many of them with assets exceeding EUR 50bn. The paper is an updated version of the original position paper which Deutsches Aktieninstitut provided in the consultation process on 23 June 2016.

Non-financial companies have generally supported the strengthening of capital requirements as well as the introduction of additional measures against possible bank failures in the aftermath of the crisis. From our point of view a strict regulation of banks is pivotal to an effective credit intermediation and a reliable provision of financial market services to the economy. We are also aware that the new regulation is not costless for banks and, consequently, the companies of the real economy. Non-financial companies have in general accepted such effects as a "price" for increased systemic stability.

Constraints would discriminate against highly solvent large corporates

However, it is our understanding that the new BCBS proposals will not only increase capital requirements even further, but generally aim at prohibiting or, at least, limiting the use of internal models (IRB) for the calculation of risk-weighted assets. This is in particular relevant for exposures to large non-financial companies (chapter 2.2 in conjunction with chapter 4.2 and 4.3.) and for so-called CVA risks (chapter 2.4).

Though the members of our working committee are users of financial services and, therefore, not in a position to comment on technical details of banks' internal models, our analysis comes to the conclusion that the consultation paper will have significant unintended consequences. In general, we are concerned that the proposed changes will lead to a significant increase of risk-weighted assets and thus of the capital buffers banks would need to build up. These findings are supported by a number of studies.

More concretely, we are concerned that the BCBS proposal will discriminate specifically against highly-solvent non-financial companies without objective reason. This may be particularly true for investment grade companies which proved reliable debtors and counterparties as well as anchors for the stability of markets even during the financial crisis. In the same way, financing conditions, i.e. prices as well as volume available, for this group of customers may worsen because we expect that the risk weights in the standardized approach will normally be much higher than in sophisticated internal models. The same may happen with undrawn credit lines. These credit lines are particularly important for the large non-financial companies because they serve as a general backup for unforeseen financial needs and usually remain undrawn. However, even if undrawn they are important for the rating agency evaluation of the companies' credit worthiness and, thus, the capital market funding as an alternative source of finance.

In a similar way, we are concerned about the proposed removal of the IRB approaches for specialised lending which could result in an even more significant deterioration of the conditions of credit provision for certain industries. This e.g. concerns the airline industry where the respective companies expect the Risk Weighted Assets to rise by the factor 3.5 to 6 and significantly above levels which are supported by existing internal models and historical data which will clearly have negative consequences on the availability and costs of finance.

Besides this, we have not yet captured the rationale for prohibiting or limiting the use of internal models regarding exposures to large corporates for systematic reasons. Basically this appears to be a move back in the design of banking regulation. The argument that in a low-default environment parameter estimation is more difficult and therefore the standardized approach based on market data estimates and external ratings is preferable is not very convincing – at least without data to support this view. According to our experience, we would rather expect that banks' internal data collected over a long period of time (credit history with customers) are more reliable than simply linking important parameters of the determination of risk weighted assets to external ratings. Therefore, we question the implicit assumption that large non-financial companies are different from others so that their default risks are difficult to model. At least and as far as we are informed, IRB models are also supervised by the authorities and have a significantly higher number of rating grades that allow for a more gradual increase in the risk weights according to the risk situation of the company.

In addition, forcing banks to use the standardized approach or limit results of internal models to a certain percentage of the standardized output may not be superior from a systemic point of view as it will increase the dependency on external ratings, which do not even exist for all non-financial companies in question. It could also be argued that some degree of variation of internal models and, thus, of the risk judgement and the corresponding capital buffers prevents homogeneity in banks' vulnerability, e.g. to external shocks.

Non-financial companies open for dialogue

Against the background of our preliminary analysis, we would appreciate if the Basel Committee evaluated and disclosed in detail the consequences of the proposal for non-financial companies before any final decision is taken. We would also be most willing to enter into a dialogue in order to provide additional feedback from the non-financial companies indirectly affected by the proposal.

Please do not hesitate to contact us if you have further questions. We remain at your disposal should you be interested in the dialogue with German non-financial companies.

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