

"Implementation Basel II" Working Group

Minutes of the 10th meeting, held on 29 November 2005 between 10.30 and 17.00 at the VÖB offices in Berlin.

1 Encl

Chaired by:

Mr Güldner **BaFin**

Mr Vollbracht **Deutsche Bundesbank**

Attended by:

Mr Baum	Deutsche Bundesbank
Dr Blochwitz	Deutsche Bundesbank
Mr Block	Commerzbank AG
Mr Boos	VÖB = Association of German Public Sector Banks
Mr Flach	Deutsche Bundesbank
Dr Gaumert	BdB = Association of German Banks
Dr Gebhard	BaFin = Federal Financial Supervisory Authority
Dr Hannemann	VÖB
Mr Hillen	Deutsche Bundesbank
Mr Judenhagen	BaFin
Mr Dr. Knippschild	Dresdner Bank AG
Mr Konesny	DSGV = German Savings Banks and Giro Association
Mr Leipold	WGZ Bank AG
Mr Link	BaFin
Mr Luxemburger	Deutsche Bank AG
Dr Marburger	
Dr Mielk	BVR = Federal Association of People's and Raiffeisen Banks
Mr Pfau	Association of German Pfandbrief Banks
Mr Raschtuttis	Eurohypo AG
Dr Reinhardt	DZ Bank AG
Dr Rohmann	Landesbank Hessen Thüringen
Mr Saure	Sparkasse Cologne / Bonn (Savings Bank)
Mr Schäfer	Deutsche Bundesbank
Mr Stein	VÖB
Mr Ströhlein	Bayerische Landesbank
Mr Webers	WestLB AG
Ms Weigold	Deutsche Bundesbank

The meeting proceeded according to the following agenda:

ITEM 0 General welcome

ITEM 1 Report on current status with regard to transposing Basel II into national law

ITEM 2 Reports on the work of the expert panels

ITEM 3 Miscellaneous

ITEM 0 General welcome

Mr Güldner welcomed all those participating and thanked Mr Boos and the other representatives from the VÖB (Association of German Public Sector Banks) for the kind invitation to their premises. He then described the day's agenda which was approved without any further requests or amendments.

AGENDA ITEM 1 Report on current status of transposing Basel II into national law

Mr Güldner stated that he expected a draft law implementing the now adopted Directive in the Banking Act (KWG) to be published during that same week. He further commented that work on the Solvency Regulation and the Regulation Governing Large Exposures and Loans of EUR 1.5 Million or More was making headway and that these would most likely be presented to the Finance Ministry for consultation at the beginning of next year.

One person attending on behalf of the VÖB pointed out that should the consultative meeting scheduled by BaFin for early December about how to handle participating interests necessitate amendments to the Banking Act, these would need to be incorporated into the draft as revisions at a later point.

In answer to a question posed by a representative of the big banks, Mr Güldner went on to say that at present there were no ongoing direct international negotiations relating to the delay in introducing Basel II in the USA. However, a case study was currently being conducted on this subject in the AIG (Accord Implementation Group) and at the bilateral level an individual case-by-case approach towards dealing with the respective banking institutions was to be expected. A spokesman for the Bundesbank expanded on this by remarking that the American side had expressed its position in the AIG statement as "to be as pragmatic and flexible as possible". Another person speaking for the VÖB said that for branches in the USA that were subject to the Accord in accordance with section 53c of the Banking Act, the American own funds and large exposure requirements would not be applicable anyway.

AGENDA ITEM 2 Reports on the work of the expert panels

IRBA expert panel

Dr Blochwitz began by explaining that the expert panel had basically completed its work focusing on the legal implementation of Basel II and was now increasingly occupied with matters of how to interpret the regulations. However, this would necessitate redefining the expert panel's mandate. Using the presentation attached (see encl 1) he explained the required

changes to the mandate and suggested steps to update existing documents concerning portfolio definition and retroactive requirements. The working group then approved these revised parameters of the expert panel's mandate and the updates.

Dr Blochwitz then discussed documentation yet to be published concerning internal auditing and PD estimation, pointing out that the paper on internal auditing requirements had been revised at the request of the working group. A VÖB delegate stated that internal auditors questioned by his association had difficulty accepting internal auditing being presented as a function, rather than what it actually is, namely an organisational unit. A BdB delegate maintained that while it was clear that the systems would have to be audited, it was equally clear that internal auditors were not happy with this abstract definition of their task. In some banks, however, the monitoring of ratings systems was not done by internal auditors and therefore there was no need to increase staffing for this purpose. The VÖB delegate proposed not referring to auditing abstractly but instead as an independent functional unit. The representatives of the supervisory authorities sitting on the IRBA expert panel were asked to reach agreement with the VÖB on the most appropriate wording and to present this in writing for the working group to vote on.

Dr Blochwitz said that the paper on PD estimation was actually the outline of a far more extensive article on the probability of default. Hence, it was in part only descriptive in nature. In reaction to a question from the representative of a Landesbank Dr Blochwitz said that the various possible ways of estimating PD did not reflect any specific preferences on the part of banking supervisors. Indeed, the bank was free to choose as it saw fit and merely had to select one of the options that had been detailed. The paper did not imply any particular focus on certain variants on the part of supervisors. The working group then approved publication of the paper.

The IRBA expert panel's work programme also covered the treatment of stress tests, on the subject of which Dr Blochwitz made an introductory presentation using the presentation material. A participant representing one of the big banks suggested that the expert panel wait for the findings of the CEBS on stress testing before addressing the issue. Dr Blochwitz spoke of an inverted line of discussion, explaining how in the recent past the initiatives of the expert panels had enabled the German supervisory authorities to exert considerable influence on international accords and agreements. Several representatives both from the big banks and the BdB urged the supervisory authorities, however, not to link the results of stress tests with the applicable regulatory capital charges. It was pointed out that stress tests only apply as part of the second pillar, as Dr Blochwitz also mentioned in his presentation. A BaFin representative elaborated on this by saying that institutions ought not to be hindered in their endeavours to carry out stress tests at present. Those passages in MaRisk referring to stress tests sufficed as a basic specification, and once the banking industry and the supervisory authorities had gathered greater experience with stress testing this could be incorporated into MaRisk through a corresponding amendment. Dr Blochwitz once again emphasised that the paper should not be construed as recommending restrictive instructions or additional capital charges. Nevertheless, contingency plans drawn up for dealing with an actual stress scenario should not prove unrealisable.

Dr Blochwitz detailed three methods of taking transfer risks into account:

1. At the score level, by reallocating the borrower to a different score
2. At the parameter level, by estimating the additional PD for transfer risk
3. At the probability of default level by estimating the degree of increase in PD

The institutions could choose freely between any of the above alternatives, whereby the third option was especially accommodating for banks that treat debtor-related risks separately from country and transfer risks.

A representative of one of the big banks opposed such detailed specification of country risks, arguing that the separate modelling of transfer risks went beyond the Directive and was probably not included in QIS 4 either. It would entail a concomitant rise in capital requirements. Someone from another big bank added that by treating transfer risks separately might level out the capital advantage of the advanced approach over the foundation approach. Together with a colleague from the VÖB he went on to say that Basel required banks merely to keep a close eye on transfer risks, with no explicit charges demanded, neither in the Accord nor in the CRD. Representatives both from a big bank and a Landesbank remarked that, strictly speaking, hardly any pure transfer risk remained. Instead, accumulated risks were more likely to result from exposure to exchange rate risks in a specific country. In a crisis situation such countries were more likely to experience an increased number of insolvencies than a halt to transfers. As the CRD makes the requirement to estimate transfer risk dependent on such a risk being demonstrable, the practical relevance of detailing specific country risks was extremely limited, and at the end of the day a transfer risk differed little from a concentration risk, which should be controlled by means of limits rather than capital.

Someone attending from BaFin replied that when a borrower was unable to pay due purely to governmental restrictions, the default event effectively worked against the client's credit rating. A Landesbank representative pointed to practical examples in Russia, where three external ratings apply to investment. The first of these assesses the creditworthiness of the client and is calculated in roubles and consequently fails to consider possible currency risks. Here, the customer would certainly be able to pay in roubles. The second rating relates to the sovereign risk, in this case Russia, and can be used to adjust the basic credit rating. The third rating evaluates the product, inclusive of any available collateral, in the specific country context. The Landesbank contributor suggested using just the first rating for the capital charge in the first pillar, and proposed considering the other two rating methods for use in the second pillar only for prudential purposes. A participating member from the BdB enquired whether the question of how to deal with transfer risks was a topic discussed by the EU in general or a specifically German "go-it-alone" approach. If the latter were the case, capital charges in the first pillar should be rejected. The Landesbank representative asked the IRBA expert panel to take account of information on implementation elsewhere in the EU, and Mr Güldner wound up by urging the expert panel to continue discussing transfer risk in the light of the points raised by the working group.

ABS expert panel

Ms Weigold of the Deutsche Bundesbank reported on two meetings held by the ABS expert panel. The first of these served primarily to enhance the transparency of provisions concerning securitisation in the Solvency Regulation. In the end the expert panel representatives acknowledged that, while the new draft was easier to understand, the complex nature of the material precluded any truly simple representation.

In the second meeting the expert panel concerned itself with comments on the Solvency Regulation using model calculations and explaining basic terms as well as employing charts

and figures to illustrate specific transactions. It also focused on the Internal Assessment Approach (IAA), dealing with approved internal methods for assessing the various components of Asset Backed Commercial Papers (ABCP). And while this kind of internal evaluation was only conceivable for liquidity facilities, it remains a necessary tool since as a rule no external rating is available for such components. The supervisory authorities are seeking to compile a checklist by March so that the contents of IRBA applications for approval could be given concrete form for this procedure as well.

A representative from one of the big banks drew attention to the great advantage that US banks would reap in this context as a result of the delay, mentioning that it was unclear whether this lead could ever be caught up with. The person representing the cooperative banks sector asked what a use-test in this field was meant to look like and also how long a comparable procedure would need to have been available for. Further, the same person wanted to know which functional areas of the bank would have to be involved and, finally, how could a six-month data history be achieved by 2007. Mr Güldner responded to these questions by explaining that the supervisors wished to manage hold-ups in this area in a flexible manner, eg using suitable conditionalities. Adopting the IRBA should not be made more complicated by the IAA. In any case, the ABS expert panel needed to consider this timing advantage for US banks when discussing flexible solutions. Ms Weigold went on to explain that the methods proposed by the expert panel reflected the very latest best practice and did not need to be adopted wholesale but rather should be tailored to meet the individual requirements of the situation and the institution concerned.

The speaker from the cooperative bank sector pressed for a fast and above all flexible solution, claiming that fall-back solutions stipulated by the Directive were not a meaningful alternative in practice, as the outlay required to successfully implement them outweighed any possible benefit. Therefore, he recommended also opening up the IAA to non-rated counterparties outside of the liquidity facilities. A speaker from BaFin said that while the IAA may be deemed a problem-solver for the particularly large-volume liquidity facilities, methodologically it was highly dubious as it was not forward-looking, and for this reason the approach was limited to use for ABCPs.

A representative of the BVR (Federal Association of People's and Raiffeisen Banks) recommended publishing the Solvency Regulation in tandem with the explanatory notes on ABS. Otherwise the ZKA (Central Credit Expert panel) would be obliged to list every misgiving in its formal comments. If such explanatory notes were not provided, its comments would be correspondingly enlarged. Mr Güldner refused to be drawn when asked about an actual date of publication, saying staffing limits along with a shortage of time made it impossible for him to give a precise answer. The Solvency Regulation had to be finalised simultaneously with the Banking Act, as it was to be presented to Parliament for deliberation. He was, however, able to confirm that the recommendations produced by the various expert panels would be incorporated into the explanatory notes in as much as they did not already find mention in the regulations themselves or conversely had been made obsolete as a result of changes made to the Directive. Someone representing the VÖB suggested it would suffice if the supervisory authorities made a general promise to use the recommendations of the expert panels as the basis for interpretation while indicating those points on which they intended to deviate from them. In response, Mr Güldner remarked that this suggestion was worth being passed on to the Ministry.

The BVR representative opined that the regulatory texts were basically worthless in the political decision-making process unless they included explanatory notes. Bearing this in

mind, perhaps the ZKA should ask the political decision-makers to dispense with blank regulatory texts altogether, so as to expedite the political process. BaFin representatives commented that work on the texts accompanying the regulations had begun directly after completion of the Solvency Regulation itself. However, only the preamble could be expected by March, ie the text outlining the structure of the regulation, remarks about the implementation of the Directive (including a synopsis), a justification of the options available and general observations on the contents. The actual explanatory notes, expanding on the Regulation's provisions and detailing the ins and outs of the technical and political discussions, could not be compiled until a later date. Mr Vollbracht observed that neither BaFin nor the Bundesbank had any real say when it came to the political process, saying that if the ZKA really wanted to move things along they would have to pressure other parties.

CRM expert panel

Mr Flach started by saying that work of his expert panel on implementation issues had largely been accomplished and that it was now concentrating on clarifying matters arising from the concrete business of putting the new rules into practice in the individual institutions as well as putting together recommendations on interpretation. This necessitated redefining its mandate in consultation with other expert panels and the working group.

The expert panel had proposed recognising the rating of the guarantor of a security issue rather than that of the issuer in the foundation IRBA, provided this was taken into account by the external rating of a (recognised) rating agency. Although guarantors often came in the shape of central, state and local government, as a rule there was no information about the features of such a guarantee, meaning that the minimum standards required of guarantees could not be fulfilled. Recognition by the supervisory authorities would have to rest on trusting in a careful assessment of the judicial enforceability of the guarantee by the rating agency. He said the banking community welcomed the expert panel's proposal and now needed to decide internally whether to actually go ahead and apply the proposal. Should the industry opt not to recognise such guarantees, an answer would have to be found to the question of how then to rate a default by the issuer of such a security if the security itself does not default.

Default guarantees would generally no longer be recognised from the year 2007 onwards. The expert panel was currently discussing whether to allow limited recognition of default guarantees for loans backed by housing mortgages as well as of guarantees from other collateral providers, possibly subject to additional restrictions. An alternative would be a flexible grandfathering solution.

OpRisk expert panel

Mr Güldner reported on amendments to the Directive, publications by the supervisory authorities as well as the work performed by the expert panel.

First of all, he discussed those changes made to the CRD in the field of operational risk prior to its adoption by the European Council. He said that offsetting of negative gross income had been permitted in the foundation approach. Income from subsidiaries had been removed from the relevant indicator field (gross income). Outsourcing expenditure could be deducted so long as the external service provider was a part of the group or was accountable to the supervisory authorities. The principle of proportionality was now being emphasised in connection with the foundation approach. Meanwhile risk mitigation through insurance cover

had been tied to a credit standard (external rating, in accordance with stage 3), and other risk mitigation instruments had received authorisation.

The supervisory authorities had duly published the relevant memorandum on authorising advanced procedures on 17 October and planned to do the same again for the memorandum on the foundation approach around mid-December 2005.

The recommendations on monitoring (validation) in the AMA and the recommendation on expected loss would be resubmitted to the expert panel on 5 December following editorial revision. The banking sector's draft recommendation on the business environment and internal control factors had been adopted by the supervisory authorities with a few minor changes. Mr Güldner expected it to be adopted on 5 December. He requested the working group's permission to e-mail the recommendations adopted by the expert panel on 5 December to its members with a view to achieving prompt publication before the end of the year if possible. Moreover, the expert panel was working on a recommendation covering insurance and other risk mitigation instruments plus a recommendation on determining the relevant indicator in the context of partial use. With regard to the latter there was general agreement among members of the expert panel on the matter of content. However, it was necessary for the supervisory authorities to conduct a further revision due to the option of offsetting negative gross income in the foundation approach. For the time being, the expert panel did not deem a recommendation on allocative procedures to be necessary.

The working group agreed to Mr Güldner's suggestion to e-mail them.

MaRisk expert panel

Mr Link reported on the consultation exercise concerning the second draft of MaRisk, following completion of work on the expert panel. Here, comments received had on the whole highlighted one contentious point, the question of whether a full strategy or (just) a risk strategy could be demanded of institutions. Mr Link stated expressly that the supervisory authorities had no intention, neither now nor in the future, of intervening in business policy and that on this basis a corresponding agreement had been reached with the ZKA which was contained in the ZKA's comments on the MaRisk draft.

In its comments, the ZKA demonstrated concern that the flexible rules and liberalisation clauses might effectively be constrained again by restrictive interpretation on the part of auditors. The supervisory authorities were trying to counteract this in various ways. Firstly, BaFin and the Bundesbank will draw up a common MaRisk auditing concept for their own audits. Secondly, banking association auditors and external auditors are to be involved more closely by giving them more seats on the expert panel. Thirdly, a corresponding guideline for auditors is to be included in the letter accompanying MaRisk.

According to Mr Link the supervisory authorities did not plan to send out any further circulars regarding section 25a of the Banking Act, other than MaRisk. As a next step, the circular concerning outsourcing is to be integrated into MaRisk. In keeping with the basic tenet of principle-based supervisory standards, this will largely omit the existing detailed provisions. A representative of the Landesbanks suggested going a step further by also doing away with the circular on cross-border remote data processing. From the cooperative sector, one speaker pointed out that the present pragmatic approach towards outsourcing had been fought for by the federation over many years and that such a tried and tested system should not fall by the

wayside as a consequence of efforts to create greater flexibility. To which Mr Güldner replied that no such changes to proven structures were planned, adding, however, that difficulties others had with the circular were countered by flexible rules.

Mr Links' subsequent remarks made it clear that the ZKA was in favour of MaRisk not coming into effect until 1 January 2008. This having been said, he pointed out that the CRD, on which certain parts of MaRisk hinged and which therefore also served to implement it, would take effect as of 1 January 2007. Mr. Güldner elaborated on this, saying that being the published version of an internal administrative guideline, MaRisk could not in fact "come into effect". From which it followed that BaFin's restricted discretion associated with MaRisk would apply immediately. When evaluating facts and circumstances and deciding on prudential measures, however, the supervisory authorities needed to take into account that the process of change and restructuring at the institutions would take time.

A person speaking on behalf of the VÖB observed that many banks were still working on their risk sustainability concept and their strategy. From the BVR someone suggested inserting an appropriate pointer to this effect in the accompanying letter on MaRisk. While two participants representing the DSGV and the Landesbanks expressed the thought that those institutions which managed to implement the first pillar early on ought not to be disadvantaged by MaRisk simultaneously coming into full effect. A representative of the Landesbanks declared that implementing the internal procedures of Pillar I was the top priority, adding that the capital concept would not be optimised until this process had been completed.

A spokesperson for the VÖB enquired how the CEBS consultative paper relating to the SRP (CP 03) would affect MaRisk. Mr Link answered that the principles of that paper had already been incorporated within MaRisk and that while international negotiations might not always be predictable the aim of the supervisory authorities was to bring CP 03 in its final version into line with MaRisk.

In closing, Mr Link stressed that there remained adequate room for manoeuvre to implement the proposals made by the ZKA.

Disclosure expert panel (Pillar III)

Mr Hillen began by noting that the expert panel on disclosure had undertaken the change requested by the working group at its last meeting in a protocol report. The expert panel now had to include those rules relating to the trading book in the Solvency Regulation and in the expert panel's own recommendations as well as on a more general level to take account of changes made to the adopted Directive in the recommendations. As far as processing the Solvency Regulation was concerned, practical examples of how disclosure operates should be supplemented by references to the Solvency Regulation. Already, examples could be viewed on the internet, with an e-mail address provided for queries. And if a question could not be answered there, it should be brought to the attention of the expert panel. To this end, the expert panel on disclosure was likewise seeking to achieve the required changes to its mandate.

AGENDA ITEM 4 Miscellaneous

1. Trading book expert panel

Mr Güldner explained that the supervisory authorities were not disinclined towards establishing a further expert panel to deal with trading book issues, however it would not pursue this actively for reasons of capacity. He asked the members of the working group to relay the wish to have this extra expert panel as a written request to the supervisory authorities, detailing the topics and issues it would handle. A spokesman for the BdB commented that some of the subjects such a expert panel would occupy itself with only affected a few banks. The matter could be meaningfully decided upon at ZKA level. One BaFin delegate offered to bring up some of the topics at the IRBA expert panel, for instance the double default.

2. Minutes

There were no further remarks on the draft minutes from the 9th meeting. When asked by a representative of the BVR about the results of the discussion concerning the possible setting up of an expert panel to deal with reporting, Mr Güldner told him that the supervisory authorities were still discussing the matter internally, but from the tenor of discussion at the last working group meeting he saw no problems concerning time.

3. Future development of the expert panels and the working group

According to Mr Güldner, the supervisory authorities would like to satisfy the banking industry's wish to establish the expert panels and the working group on a long-term basis as advisory bodies with the remit to interpret prudential rules. It remained to be seen how the expert panels on MaRisk and own funds could be integrated into the working group. According to a representative from the VÖB, full integration of the expert panel on own funds was necessary, if recommendations concerning prudential recognition of own funds components were to be made there. A recently published study by the CEBS on this subject was of interest in this connection. A Landesbank speaker continued that details on the implementation of waiver provisions had to be clarified as soon as possible. Changes to the group of consolidated enterprises, sub-consolidation and the calculation of Principle 1 at single-entity level were awkward to implement in IT terms. Mr Güldner responded that the forthcoming draft of the Banking Act went some way towards answering these initial questions.

4. Restructuring of BaFin

A representative from the VÖB asked for the banking industry to be officially advised of the restructuring plans pertaining to BaFin as the information thus far had proved unsatisfactory.

5. Reporting under Basel standards

A representative of the supervisory authorities confirmed that separate reports in compliance with Basel standards were to be compiled by the respective institutions for the last time by the deadline of 31 December 2006, after which just one report was to be submitted based on the CRD.

6. Building and loan association mixed weighting

Dr Gebhard announced the desire to raise building and loan associations' mixed weighting for capital charges on the mortgage-backed part in the Solvency Regulation from its current communicated level of 70 % to 80% and asked the members of the working group to report back any misgivings.

Head of the working group:

Mr Güldner

Minutes of the meeting:

Mr Vollbracht