9-8-2010

Interview notes BaFin

Landon Stroebel

Sven Deckers

Frank Pierchel

Thomas Shmitz-Lippert

Ludger Hanenberg

See next page for additional authors

Author/Creator
Landon Stroebel, Sven Deckers, Frank Pierchel, Thomas Shmitz-Lippert, Ludger Hanenberg, Tony Ingoglia, Daniel Mestek, Thomas H. Stanton, Steve Sanderford, and Joel Miller

BaFin

Wednesday, September 08, 2010
11:00 AM

Frank Pierchel
Thomas Shmitz-Lippert
Sven Deckers
Ludger Hanenberg
Daniel Mestek

Landon Stroebel
Tom Stanton
Joel Miller
Tony Ingoglia
Steve Sandeford

Question 1: Prior to the crisis, how did BaFin address German bank commitments to off-balance sheet vehicles such as asset-backed commercial paper conduits? Has that changed in the aftermath?

The requirement of having the entire risk has not been enlarged to off balance sheet as well. Some conduits were perfectly intact in some foreign countries. According to their laws, they were not required to report the balances for some subsidiary off balance sheet assets/liabilities.

They now observe all of this as a consolidated supervisor, however this is ultimately a few years too late. They are now discussing this issue again regarding the risk profile. We now incorporate all aspects, specifically the off-balance sheet for SPVs.

FCIC: We found that because of reputational risk, some large financial institutions chose to support off balance sheet accounts, even if they were not obligated to do so. Did you have the opportunity to review these decisions?

BaFin: We saw things very similar to this. From a reputational point of view, many firms find it necessary even if there is no legal requirement for them to assume the off balance sheet firms. In general there is a tendency to draw back to include them onto the original balance sheet of the parent bank. That was a development that they observed as well. Some banks definitely had to deal with this much more significantly than others.

FCIC: One of the features that these conduits were structured (under Basel II) in the US, they were outside some firm's oversight, but they still had independent requirements under Basel II. Most of these still had significantly lower capital charges. What developments did you see in these channels?

BaFin: There have been several shortcomings due to use of Basel II criteria when the crisis started. Those SPVs (SIVs or Conduits) are now part of the consolidated regulatory oversight, must be consolidated with the parents. Also, new risk management rules must be developed and maintained to address these risks. There is an amendment also regarding the liquidity lines that had been given to certain lines at certain conduits. Some lines only went to 364 days, which were not part of the supervision prior to the crisis, often viewed as a definite loophole due to not having to have the capital charge if the line was not drawn.

FCIC: The FASB accounting changes at the end of 2009, eliminated off balance sheet programs here as well. The regulatory framework does not extend a special provision for ABCP. Is this exactly the same as what occurred in Germany.

BaFin: Yes, we amended both systems. The accounting provisions as well as the regulatory consolidating circle. The capital oriented banks must include the SPVs for their consolidated balance sheets. Now all the regulatory framework includes all of these as well.

FCIC: For this change, the management of those programs said it will eliminate this business altogether or that it will go over seas (in the US). How much push back did you receive? There is still a considerable push back on this, to bring back capital preferred treatment.

BaFin: We did not have too much of this discussion, because in Germany & EU level, this sort of treatment of these hidden risks was one of the major contributing factors in causing the crisis. The EU also established an additional requirements for securitizations, under the Basel II enhancements.

The changes are completely in line with the enhanced Basel II framework. All SPVs must now be on their balance sheet. There are only a few SPVs that are left to be independent, given this new law. What we also observed is that this type of securitization has declined significantly, there are definitely certain kinds of business that will not come back.

FCIC: Do know what the capital charge was for 364 day duration?
BaFin: It used to be zero for undrawn facilities, full charge if they were drawn whatsoever.

FCIC: In the US we increased it to 10% in 2004.

Question 2: What regulatory factors were influential in the accumulation of US subprime risk in German banks?
Bafin: One of the sectors was this off balance sheet aspects. However there are two other important aspects. The over reliance on ratings and outsourcing of credit risk supervision. Secondly there is the overwhelming importance on incentive systems and management of these systems within large institutions. Stress of short term successes, immediate performance compared to long term success.

You have to keep in mind that the German banking market involves some very large players that have the potential to be involved with certain markets given their investment bank nature. The banking business in Germany is not very profitable, so they turn to other aspects typically to achieve the add on profitability, by taking on additional risks.

Another regulatory factor is the reliance on ratings. Too many investment decisions are made/based on ratings. Up until the crisis, this reliance on ratings proved to be tremendously too high. They had no investigation behind the scenes.

Two other factors that worked in favor of these developments. 1: The need or room for stronger set of rules for capital add-ons. We had this in the past, but it was perhaps too narrow, so they now have wider views regarding the scope of these capital add-ons. 2: The internal control mechanism within banks has not worked very well. This is true for several supervisory boards, the non-executives of the board needed to improve upon these risk management practices. This topic must be focused in a much more comprehensive and focused way.

FCIC: understand the regulatory arbitrage, typically the riskiest investments were transferred to the less regulated aspects of these companies.

BaFin: Yes, correct. Purely observational though, we don't have empirical data of this.
We have clarified our legal provisions, bank are no longer allowed to outsource certain functions that are not within their regulatory oversight. Any behavior they engage in must be within their own regulatory framework.

FCIC: What activies are we talking about here?
BaFin: Key risk management functions, functions that are within the capacity of the board of management must remain in the bank. It really includes any add-on that was available to any of these institutions that was not typically within their traditional framework.

FCIC: Were any of those subsidiaries located in the US? Were they in Tax Havens?
BaFin: Some banks are using some legal entities that are registered in Deleware, founded for tax reasons. Such enterprises can definitely be found in tax havens.

FCIC: Some institutions outsourced risk management? Advisory services or Risk management in total?
BaFin: The entire bundle had been outsourced.

FCIC: Regarding the compensation issue, we have heard repeated fears that if we impose compensation restrictions in certain industries, things will be shifted out of the market or to other countries entirely.
BaFin: The redefined compensation system doesn't mean that it is necessarily less, but just a much more risk based approach and long term focus than is currently in place.

FCIC: You mentioned German banking as being less profitable. Why and compared to whom?
BaFin: The comparison is with international markets. The less capital structure is very much related to an old German banking system. 3 pillared banking system in the German banking system. The competition of the German market banks, private banks and leading investment banks because the savings banks and corporate investment banks. In Germany there are so many small banks, they lack the capacity to remain competitive in pricing etc. They do not have a lot of concentration. There was no real large bank that dominated the entire market. There is definitely some stability that arises from this smaller and fractured market.

FCIC: The German market is definitely well diversified. Talk about some banks that got into trouble with subprime product, US subprime to be specific. Was there any German subprime product?
BaFin: No, they were typically invested in the international products only. This is due to the lending behavior in Germany. They have very strict rules for lending practices, must be at least 20% financed by the borrower funds (Maximum of 80% LTV), which eliminates a lot of the possibility to subprime issues.

FCIC: Do you have Home equity line of credit or 2nd mortgages as an instrument?
BaFin: It is impossible/illegal to have a 2nd mortgage to circumvent the LTV requirements.

FCIC: In the US, the lender who made the first mortgage often took so long that the 2nd mortgage lender wouldn't have time to see whether or not there already is a lien against the property given our registration process is lengthy.
BaFin: In Germany, it's a very fast process. It's impossible for that to happen to us. It's a public record.

FCIC: Is there a covenant in the agreement that dictates the seniority/junior chain.
BaFin: The borrower that does this is so much more risky than a borrower that doesn't take that device. There are strict laws governing this process.

FCIC: When you talk about the subprime market, is there public policy discussion within the regulatory community about subprime borrowers access to credit and the theory of owning a home. Is this also public policy in Germany?
BaFin: I don't know of anything in Germany as being dominant like that theory in the US. 2/3 of homes are rented, whereas 1/3 are owned. This has been very stable for many years.

One additional aspect for consideration, one reason the subprime crisis occurred in the US was because the client who was owning loan was able to give back the loan to the bank, so he only gets rid of the home (& the loan for that matter). THAT IS IMPOSSIBLE IN GERMANY! You can get rid of the home, but you can't get rid of the loan (implications to US bankruptcy code).

Question 3: It is our understanding that European regulators do not perform on-site bank examinations. What actions do European regulators (and BaFin in particular) take instead to monitor the health of their supervised banks?

BaFin: They do their own examinations and also partner with other regulatory bodies, in order to achieve a complete picture of the bank. They do modeling examinations, risk management, etc. for further detail of what is done at the given bank.
They have a long history of using auditors for examination. They have over 200 supervisors in one branch and then another 200 at Bundesbank. They do a lot of onsite work. They frequently visit banks, almost permanent on-site supervision. They regularly visit supervisory board meetings, which is not very popular at many banks. They have those powers, and they use them.
What we have in the US is that permanent on-site supervision is having someone there 24/7 at all times. They don't have this, but they have permanent proximity, but not necessarily permanent onsite supervision.

FCIC: Do you go to your overseas bank branches?
BaFin: Yes. As this industry grew, so did the regulatory body that is necessary to oversee this industry. They work in constant contact with the branches of foreign countries.

FCIC: Do you share written exam reports with foreign regulators?
BaFin: Of course, we are constantly working in concert with these. These banks are everywhere, we must cooperate. There is very close cooperation. In the EU there is the ability to transfer the responsibility to the on-site host supervisor. It's all to promote sharing, incorporate the idea of regulating these entities collectively.

Question 4: How do German regulators (BaFin or the Bundesbank) address systemic risk?
BaFin: They have a list that came from Basel II. All big institutions, many of the highly interconnected institutions are on their list as being possible systemically important to the system. This list is constantly

under review. There is a risk profile that is generated for each institution that reaches certain thresholds. They work to avoid stigma affects that may arise from being a part of this list. If an institution is rescued in Germany ,they have created restructuring acts, designed to help mitigate the stigmas. They have a systemic wind down process that is defined by their own codes.
They are constantly working in concert with financial stability board and in compliance with Basel II at all times. They support the approaches taken by the FASB to address this issue for systemic risk. They are struggling to address this problem in a way that doesn't promote firms to take oversized risks, but also provide a systematic approach to winding down these companies.

There is a new supervisory board that looks at market developments and any new potential threats that can shock the system. The comfort and goal is that they gather and disseminate a lot of risk management data. This risk committee is completely focused on this goal.

FCIC: How would this new committee addressed the prior issue of the capital add-ons as discussed earlier?
BaFin: They would make concrete proposals on how to address these risks, such as "conduct a horizontal review" that incorporates these off balance sheet assets/liabilities.

FCIC: One of the critical issues of systemic risk, aside from size and leverage, is interconnectedness. How can you detect this aspect in critical areas?
BaFin: They can't predict interconnectedness, it is very much a psychological issue. It was not due to real figures or values, but rather a fear that was rampant throughout the market. It was unseen by so many (regulators, market participants, etc.) Interconnectedness is too hard to measure and that's why the main triggers are going to continue to be size. Any component of interconnectedness that can be easily obtained will be used if possible.

Thought there could be a better approach/opportunity to detect this interconnectedness, they ask large banks to perform a mapping exercise of their major counterparties for a better understanding of their interconnectedness.

FCIC: We found some banks that thought they had backed out of subprime, but were still exposed by a loan warehouse. This may be more of an aspect of risk management.
BaFin: The international corporations would often receive notifications from their local markets to better understand the role of the bank in the local/regional market.

Question 5: Do all German banks fall under one regulator? Or is there a more fragmented supervisory system, as in the US? If the system is fragmented, were there any coordination issues between regulators?

BaFin: Yes they are an integrated bank supervisor that consolidates under them. Work in concert with the Bundesbank, which does data gathering and processing. They are also a portion of the supervisory contact. They have offices all over Germany.

FCIC: Is the Bundesbank acting on your behalf, using their 200 supervisors to support your own supervisors.
BaFin: Correct. That have the ability to co-op any project, but we normally work in concert.

FCIC: Does Bundesbank focus on any institution compared to your own?

BaFin: They have regional offices that are often very close and able to respond quickly and on site to provide them excellent/immediate feedback. However, they are not allowed to do any supervisory actions against any institutions. It eventually has to come back up through their agency.

FCIC: Does the Bundesbank deal with the international aspect of their own banks?
BaFin: Yes they do, they have the most experience and are most familiar with market developments. There are a lot of issues that will occur on a daily basis and they are most apt to successfully address these issues.

This is a very less fractured environment than in the US.

FCIC: Does BaFin regulate all levels of financial institutions?
BaFin: Yes. Banks, Investment Banks, Mortgage Brokers, etc.

Questions 6: To what extent was capital arbitrage a problem with German banks? Did BaFin address this problem with major financial firms in the period through 2008? How?
BaFin: Not really in touch with the repo business. Tendency seems to be that this was a special issue and not necessarily a big issue for their banks. What they saw during the crisis was the use of SPVs to use/save/hide capital.

Regarding repos, there are weekly reports on liquidity issues, making it difficult for a firm to build up a repo position.

FCIC: There were a couple of accounting frameworks that allowed mortgage lenders to have two methods: originate to distribute and also the originate and hold. What do you think about the var trading model & the ability for the regulatory agencies to respond in appropriate manner?

BaFin: You're referring to Basel II framework?

FCIC: in 1996, there was the BIS framework (market risk framework), allowed for large volumes of mortgages to fall outside the capital charge framework because of the likelihood that they will be sold later on.
BaFin: They have not seen this sort of arbitrage in their passing. In Basel II there are some provisions that deal with commercial real estate. They wouldn't recognize this as being capital arbitrage, the banks have to prove that there is real risk transference. Otherwise, they wouldn't accept that there really is any risk transference, and therefore subject to appropriate capital charges. There is a special instrument in Germany that is described as Mortgage Bond, which is drastically different from traditional mortgages. Mortgage Bond must prove that there is incredibly low rate of default.

FCIC: our regulators have serious disputes over the leverage ratio that should also be overlaid on top of Basel II.
BaFin: They are not too happy about the leverage ratio because they are so often compliant with Basel II. There are some unquantifiable assets that are in the portfolio, it would be good to include additional method of managing this risk. The G20 process requires this. Still some debate about how the leverage ratio will be implemented. It is too crude of a measurement to use it across all companies.

Question 7: Can you please provide us with public documents detailing risk management practices at major German financial firms in the period through 2008? Can you recommend any more profound analysis of the risk at DB that they in fact took effective actions?
BaFin: Briefly, the German supervisors tried to improve the risk management for all banks. The account regulation (minimum requirements for risk management). There are rules as to how to deal with risk management.

It is true that leveraged finance issues is due in large part to the "pipeline" issue, in that they were caught as being exposed to market turbulences so much more so than typical end game users. They were good at avoiding concentration and credit risks, however they were still subject to the market risks.

What they were able to do is that they were able to get rid a large portion of the leveraged assets.

The lessons Deutsche Banke learned? They established new risk management procedures, they integrated the risk management approaches to make sure that they are uniform across all aspects of their operations.

FCIC: Risk management can be a formal exercise without effect. If DB can get it wrong even though they looked very good before, what does this mean?
BaFin: One reason they launched so many inspections is to confirm that these risks are really being estimated in the proper fashion. DB is unique compared to other banks in Germany. DB is heavily invested/engaged in investment strategy, whereas other banks are nowhere near this level of involvement.

FCIC: You're relatively confidant then to understand the quality of the risk management than the banks' own managers?
BaFin: Yes, they are afforded the vantage point of seeing other members and also the ability to see market conditions. It seems to be fruitful for the bank as well.

Question 8: Can you please provide us with public documents detailng how German financial firms were affected by exposure to US mortgages and other assets? Are there any public documents that would discuss the quality of risk management and supervision of these?
BaFin: The website of the Bundesbank has a good report.

Annual report 2009, but the English report should be available soon.

FCIC: You have the authority/ability to address governance? Do you feel comfortable going in that their CEO is too dominant?
BaFin: That is a very real issue. You must constantly try to address the issue to supervisory board and have your rationale/reason rooted in good logic and sound reason. They definitely have the opportunities to do so. They have drastically increased the powers of supervisory boards.