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EFBS comments regarding the European Banking Authority (EBA) discussion paper on improving the regulatory framework for the internal ratings-based approach (IRB Approach) - EBA/DP/2015/01

The European Federation of Building Societies (EFBS) is an association of credit and other institutions promoting and supporting the financing of home ownership. Its purpose is to encourage the idea of acquiring home ownership in a Europe that is converging both politically and economically.

The members of the EFBS are specialised credit institutions established in eight Member States (D, AT, RO, SLO, HR, CZ, LUX and H). The business of the Bausparkassen is regulated by specific national Bausparkassen Acts. In compliance with the strict legal provisions, the Bausparkassen offer contractual savings schemes to their customers and grant them loans which must be secured by mortgage. They are not allowed to practise other forms of banking business. They may invest their excess liquidity only in particularly secure investment products, such as government bonds of EU Member States. Bausparkassen are subject to specific supervision by the national authorities. In the context of Bausparen the interest rates on savings and loans are fixed in advance and are usually lower than the market interest rate. In most Member States, Bausparkassen must obtain specific approval from the supervisory authority before offering a new tariff or a new product on the market. As part of this product testing, Bausparkassen must prove the sustainability of their products and tariffs.

The EFBS supports the EBA's endeavour to build trust in the application of internal rating systems. However, the Bausparkassen see this discussion paper as closely related to various other standards and guidelines currently in development, consultation or review. Some of the described amendments to the existing rules applicable to IRBA systems would result in radical changes in institutions' models and systems.

In addition to the substantial professional effort involved in completely restructuring all subcomponents of the IRBA systems, very considerable IT input is to be required, as adjustments to the basic data in existing IRBA systems will render the existing historical data unusable in some cases. In combination with institutions' efforts to implement other regulatory innovations (such as those introduced by the Basel Committee with BCBS 239), the proposed interventions will massively increase the risk to the quality of data processing. For that reason, we are currently highly critical of the changes. We are concerned that the volume of the required changes will ultimately weaken trust in the application of internal rating systems.

We therefore welcome the opportunity to respond to some of the questions raised in the discussion paper, as follows:

Q 1. The proposed prioritisation of regulatory products is based on the grouping of such elements that in the EBA's view can be implemented in a sequential manner. Do you agree with the proposed grouping? If not, what alternative grouping would you suggest?

To the extent that changes to the IRBA systems are required, the proposed prioritisation and approach are plausible. For reasons of consistency, changes to the definition of default and the PD and LGD estimations must, of necessity, be implemented simultaneously.

Q 3. Do you consider the proposed timeframe reasonable? In particular do you consider reasonable the proposed timeline for the implementation of the changes in the area of:

- a. definition of default;**
- b. LGD and conversion factor estimation;**
- c. PD estimation;**
- d. treatment of defaulted assets;**
- e. CRM?**

The required interventions substantially increase the risk to the quality of data storage, especially if institutions have to deal simultaneously with the professional and IT-related challenges resulting from other regulatory innovations (such as implementation of the Basel Committee's document BCBS 239) as well. Sufficient time must still be available for the tests that are essential for quality assurance. In view of the considerable overall effort required, the timeframe does not, in our view, appear adequate.

However, a firm statement on the requisite timeframe – especially for implementation of changes to the definition of default – can only be made once the changes are known. The question of whether a change must be applied retroactively is of particular relevance in this context.

Q 4. Are there any other aspects related with the application of the definition of default that should be clarified in the GL?

It would seem sensible, in our view, to clarify that retroactive application of an amended definition of default is not necessarily required. It cannot be assumed that all the requisite information will be available in the historical data. This applies to changes to the counting of days past due, materiality thresholds and the qualitative criteria applied to establish a default event.

Q 5. Do you have experience with adjustments of historical data? What are the methods that you used to adjust historical data, including both internal and external data?

The experience of the Bausparkassen is limited mainly to smaller adjustments of historical data for evaluation purposes or for the introduction of test systems. Experience has shown that adjustments of historical data require substantial professional and IT-related effort, not least in order to control the high risk of error.

Adjustment of the data is advisable only on a separate parallel system, where the data stock can be used to develop new models. Retroactive adjustments of the productive data stock, on the other hand, should not be undertaken.

Q 6. To what extent is it possible to adjust your historical data to the proposed concept of materiality threshold for the purpose of calibration of risk estimates?

As described above in the answer to Question 5, adjustment of historical data is advisable only on a parallel data stock used for model development.

Interventions in the productive data landscape offer major scope for error. Diverse interactions must be considered when adjusting historical data, as inconsistencies can easily arise. Experience has shown that such interventions would increase the complexity of data storage systems to such an extent that they must be viewed extremely critically in terms of the provision of reliable data over the long term.

Q 7. What is the expected materiality of the changes in your IRB models that will result from the proposed clarifications as described in section 4.3.2?

The changes in the IRB models may be regarded as material. This applies especially to the revision of the definition of default, the PD and LDG estimations, and the internal time series relating to historical data. In other words, all the models in operation would, as a rule, be affected.

Q 8. Do you consider the direction of the proposed changes adequate to address the weaknesses and divergences in the models across institutions?

In the view of the Bausparkassen, the comparability of the models would minimally increase. Making it easier to compare models will not, however, enhance the informational quality of the rating systems and the computation of risk associated with lending operations. Compared with the slight increase in comparability, the amount of effort involved in implementation by the institutions is disproportionately high.

Q 9. Are there any other aspects related with the estimation of risk parameters that should be clarified in the EBA guidelines?

Representative business cycles of different lengths generally apply to the various segments of portfolios. It should therefore be possible to apply, if necessary, different timeframes for the determination of long-term averages for the various segments of portfolios.

Q 14. Do you expect that your organisational structure and/or allocation of responsibilities will have to be changed as a result of the rules described in section 4.3.5?

The requirement for independent credit risk control and validation units may result in major changes in some circumstances. Separating the validation function from the credit risk control unit, developing models and establishing an independent validation unit, which must operate separately from the credit risk unit all the way to Board level, would require substantial effort. As highly qualified staff would be required for both units, this would lead to permanent overstaffing in the two units.

In its consultation paper on the assessment methodology of the IRB Approach, the EBA states that the assessment of the adequacy of the level of independence should be based on the proportionality principle. As a minimum, in smaller institutions, the staff performing the validation function should be separate from the staff responsible for the model design or development working within the same unit. However, for smaller institutions, this requirement is often almost impossible to fulfil, since they

generally have only a few employees responsible for model design, development and validation, usually working within the same unit. Nevertheless, it is compatible with the principle of an objective assessment of the rating systems if employees responsible for model development and validation work in the same unit with interchangeable roles as long as one person does not perform the two roles for the same model.

The assessment of the adequacy of the level of independence must, in our view, be based on the unrestricted application of the proportionality principle. Accordingly, due to their homogeneous, stable and low-risk loan portfolios, specialised credit institutions such as the Bausparkassen, whose retail business is focused on a national market, should in every case be classed as smaller institutions in terms of the EBA standards for the IRB approach. Should this prove to be impossible under the new standards, the institutions would face the prospect of major and disproportionately burdensome changes to their organisational structure.

Q 15. Do you agree that CRM is a low priority area as regards the regulatory developments?

Yes.

Q 18. Would you support EBA Guidelines targeted at disclosure requirements related with the IRB Approach and taking into consideration the proposals of the Basel Committee on those requirements? Which current disclosure requirements should be given the priority? What should be the timetable for such Guidelines?

The Bausparkassen see no need for a revision of the disclosure requirements.

Q 19. Would you like to see any modification of the reporting framework implemented in terms of IRB exposures?

No.

In its Discussion Paper on the Future of the IRB Approach, the EBA makes reference to other EBA drafts. The EFBS therefore wishes to draw attention to its following Comments:

- Comments regarding EBA/CP/2014/32 of 30 January 2015
- Comments regarding EBA/CP/2014/36 of 12 March 2015