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### **EFBS position paper on constraints on the use of internal model approaches (BCBS 362)**

The European Federation of Building Societies (EFBS) welcomes the opportunity to participate in the consultation procedure of the Basel Committee on Banking Supervision on constraints on the use of internal model approaches (IRB approach) to measuring credit risk.

The EFBS is an association of credit institutions and organisations that assist in and support 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. Bausparkassen grant loans secured by residential property to finance home ownership as a bulk business. In addition to this Bausparkassen are also allowed to make investments, however only in particularly safe investment vehicles. In times of crisis, Bausparkassen as specialised credit institutions have proved to be particularly resistant. Their low-risk business model is determined by the strict legal provisions for the Bauspar business and for the reduced possibilities of financial investment.

The EFBS supports the initiative of the Basel Committee to reduce the complexity of the regulatory framework and to address excessive variability in the capital requirements for credit risk. By reducing variability, the aim is to reduce the differences in the capital requirements which are not attributable to differences in risk.

However, in our opinion, the consultative document contains some measures which lead to a reduction of justified differences in the risk-weighted assets (RWA). To some extent, the planned measures bring about a significant exaggeration of the credit risk in the case of low-risk portfolios – extending well beyond the necessary prudence – and therefore a considerable rise in the capital requirements.

We should like to comment in particular on the following sections of the consultative document:

#### **Re 1. Introduction; Output floors**

The Basel Committee pointed out that the proposed restrictions of the IRB approach are to be supplemented further by capital floors based on standardised approaches. In the case of restrictive capital floors, it is of course in particular institutions conducting low-risk business, for example with a high proportion of retail business exposures, which will be disadvantaged.

We therefore propose limiting the variability of the IRB approach fair according to the input involved – i.e. primarily through more precise specifications for the parameter estimations.

In so far as a capital floor nevertheless were to appear necessary to the Basel Committee, it should in our opinion be taken into consideration that the RWA of an unchanged portfolio under the standardised approaches will be increased considerably through the planned changes to these approaches. In the event of retaining the floor amounting to 80% of the capital requirement under the standardised approaches, its restrictive effect would as a result increase considerably. If this floor is retained, we therefore consider its reduction to a maximum of 60% of the capital requirement under the standardised approaches to be necessary.

## **Re 2. Scope of use of internal models;**

### **2.2 Exposures to banks, other financial institutions and corporates**

The proposed removal of the IRB approach for exposures to banks and large corporates leads to a considerable increase in capital requirements for institutions which use internal rating in this respect. This is attributable to the fact that then, for these exposures, due to the in part low degree of coverage with external ratings, often only the 100% risk weight can be applied. In particular, institutions which have specialised in asset classes for which the use of the IRB approach is to be prevented, would be hard hit. Institutions which can no longer pursue their conservative, low-risk investment strategy would have to consider channelling their investments towards higher-risk investments.

Bausparkassen, in addition to housing finance, in principle may make investments only in particularly secure debt securities, predominantly issued by states and institutions of the European Economic Area, or place liquid assets in bank deposits. For Bausparkassen, whose investment options are limited by national Bausparkassen Acts and which therefore have fewer alternatives, a considerable increase in capital requirements would result.

We therefore emphatically advocate that institutions should continue to be able to use the IRB approach for exposures to banks, other financial institutions and large corporates.

## **Re 3. Parameter floors; Loss given default (LGD)**

Already since 2007, IRB approach Bausparkassen determine loss given default with the help of the LGD models accepted by the competent supervisory authority, which are constantly validated and regularly subjected to thorough assessments – including by the supervisory authority. So far – throughout the financial and economic crisis – these models show very stable LGDs at a low level. However, already with the establishment of LGD floors in the European Regulation on prudential requirements for credit institutions (CRR), the precise risk measurement intended by the IRB approach has largely been deprived of its effectiveness. For Bausparkassen, the LGD floor for all retail exposures secured by residential property of 10% (CRR Article 164 (4)) is of decisive importance.

In current lending practice for the financing of residential property, especially in Germany, the loan-to-value ratio is assigned a key role in risk management. Bausparkassen typically

undertake financing up to a loan-to-value ratio of 80%. On the stable property market, the average actual loss rates are frequently below the current LGD floor of 10%.

A new LGD floor for loans secured by real estate of 15% would therefore be equivalent for Bausparkassen to increasing the capital requirements for loans secured by real estate by 50%. The aim of the Basel Committee in principle to keep the capital requirements stable already therefore cannot be achieved for Bausparkassen on account of the new LGD floor.

Also the introduction of an overall LGD floor of 30% for unsecured retail exposures in our opinion does not seem appropriate, since, depending on the type of financing and the business model of the institutions, differing and often distinctly lower average loss rates are achieved. The institutions should therefore in our view remain in the position to use risk-adjusted LGD ratios in the calculation of the capital requirements. The appropriateness of the LGD ratios specific to the institution is in our view a core advantage of the IRB approach, which should not be relinquished at the cost of comparability which, although covering all banks, is only apparent.

Furthermore, it is to be assumed that institutions – especially in the current low interest rate environment – often will not be in a position, in a retail portfolio with its lowest risk exposures, to cover the respective costs of capital, since these exposures result in the same capital requirements as the higher risk exposures in the portfolio. Profitability considerations then become the reason for a change in the focus of lending to exposures with a higher average risk and lead to a deterioration in the quality of credit portfolios.

We therefore ask, as a matter of urgency, for the introduction of as few floors as possible and where appropriate to set these at distinctly lower levels so that they represent a limiting factor only in the area of extreme values of a parameter.

#### **Re 5. Other issues; Partial Use**

The Basel Committee is currently considering whether the possibilities to apply the IRB approach temporarily or permanently to individual portfolios should also be amended.

We see no need in principle to change anything in the existing regulations on Partial Use. Under no circumstances should IRB approach institutions be forced to apply the IRB approach to segments if this makes no sense in terms of the credit risk or the additional cost.

Finally, we venture to add to our request the indication that several current regulatory initiatives of the Basel Committee will have the result of raising the regulatory capital requirement for Bausparkassen – beyond the extent provided for in the Basel III framework in any case. An additional burden arises for Bausparkassen in particular from the following measures:

- Revisions to the Standardised Approach for credit risk – BCBS 347,
- Constraints on the use of internal model approaches – BCBS 362,
- Capital floors – BCBS 306,
- Revisions to the Basel III leverage ratio framework – BCBS 365 and

- Standardised Measurement Approach for operational risk – BCBS 355.

We welcome the Basel Committee's intention not to allow the capital requirements to increase as a whole as a result of the final work on Basel III. The Basel Committee has also declared with regard to individual measures that in principle they are not intended to increase the capital requirements. However, for Bausparkassen, as the consultative documents currently stand, there is in each case an increase in burden. The cumulative effect of the new regulations shortly to be applied simultaneously on the capital requirements can in our view no longer be deemed acceptable.

We therefore consider it to be necessary to review the proposed restrictions on the use of the IRB approach.

We welcome the fact that the Basel Committee wishes to assess the effects of the proposals on the IRB approach by means of a quantitative impact study. We consider it essential that in future the cumulative aspect of the various new regulations is also covered in the Basel III monitoring.

Yours sincerely,



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