European Federation of Building Societies
Fédération Européenne d'Epargne et de Crédit pour le Logement
Europäische Bausparkassenvereinigung

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EFBS position paper on: ''Implementing the final Basel III reforms in the EU"

The European Federation of Building Societies (EFBS; Europäische Bausparkassenvereinigung) 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 Europe that is converging both politically and economically.

The members of the EFBS are specialised credit institutions established in several Member States of the European Union. 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. 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 Basel standards constitute homogeneous rules for all institutions regardless of their size. National differences in the banking landscapes, such as those between the USA and the EU, are not taken sufficiently into account in the design of the standards. The diversified and heterogeneous banking market in Europe is hardly born in mind. A 1:1 implementation of the final Basel III standards and its application to the many small and specialised European institutions would not be appropriate against the background of the proportionality principle.

Before implementation, the Basel requirements should be checked for proportionality and any regulatory discrimination against credit institutions with a simple and non-complex business model should be avoided. For the EFBS the following points are in particular relevant.

Standardised approach for operational risks

Business Indicator (BI)

The calculation of the capital requirements under the new standardised approach for operational risks is based inter alia on the business indicator (BI) and the service component it contains. For the calculation of the service component, the maximum of fee income or fee expenses is taken into account. No provision is made for netting income and expenses even where they are fully interdependent. That means that the higher the fee income and expenses are, the higher are the capital requirement.

Contrary to the assumption of the Basel Committee that the restructuring of the standardised approach does not result in a significant increase in the capital requirements for operational risks, it will lead to a considerable additional burden particularly for fee-based credit institutions such as Bausparkassen. The business model of the Bausparkassen is strongly fee-driven. Due to their distribution structures, the Bausparkassen mostly pass on the fees received from the customer 1:1 to the external sales representatives. In our view, this does not indicate an operational risk, especially as Bausparkassen make no advance payments and the fee income and fee expenses are essentially directly interdependent. The plan to take into account the maximum of the fee income and fee expenses in the context of the service component does not lead to a realistic risk assessment in the case of fee-based business models.

Actual operational risks regarding the service component for Bausparkassen result from claims and scenarios, in which Bausparkassen have to refund provisions. In 2019, we last asked the Bausparkassen in Germany to what extent they recorded claims in the area of sales and which part of the RWA in OpRisk are based on the service component. We received information from Bausparkassen which together account for over 80 percent of the bauspar sum newly signed in Germany in the past three years. On average, around 40 percent of the capital requirement for operational risk according to the new SMA in its planned design would be due to the questionable calculation of the service component. The amount for the necessary capital requirements resulting from claims only reached about 3 percent of these capital requirements to be calculated for the service component. This example shows to what small extend the actual risk of Bausparkassen results from the provision system. The Basel design of the service component requires an underlying with own funds that is more than ten times higher than the actual risk. Therefore, the capital requirements for operational risk according to the new designed SMA do not reflect the actual risk but go far beyond it.

In addition, in the case of distribution structures involving independent sales representatives (external sales representatives) or other institutions working on a fee basis, these fee payments are recognised to the full amount as expenses in the service component. If, on the other hand, distribution takes place through employees with a fixed salary component, fee payments are not taken into account. This difference in assessment of cash flows relating to the distribution of financial products is due only to the distribution channel and gives no indication of an inherent operational risk. However, for institutions using a strongly fee-dependent distribution channel via independent sales representatives or other institutions, this leads to a significant disadvantage in the risk calculation under the standardised approach for operational risks. **When implementing the final Basel III framework, we therefore strongly urge that the netting of fully interdependent fee income and fee expenses is permissible.**

The Internal loss Multiplier (ILM)

We welcome the initiative of the Basel Committee to take historical data and the institutions experience into account. In our point of view the own fund requirements should be calculated at least in parts on the basis of the institutions business model and risk appetite from the past. **In this case, the Internal Loss Multiplier is an appropriate instrument to calculate the requirements and also to alleviations, if the ILM is smaller than 1. This describes a suitable tool and incentive for a well balanced business model.**

Boundary between the trading book and the non-trading book

Under the Basel standards on capital requirements for market risks, the boundary between the trading book and the banking book and the relevant criteria for the respective allocation of the instruments held in the portfolio of the institutions was redefined (RBC25.8). According to the new regulation, funds with a look-through on a daily basis are to be allocated to the trading book. The allocation is to occur independently of any intention to trade on the part of the institution and has the consequence that many institutions, which are non trading-book institutions and have no intention to trade, would become trading-book institutions in the event of a 1:1 transposition of the Basel provisions and therefore would be subject to stricter requirements.

Specialised non-trading book institutions such as Bausparkassen pursue by law a risk-averse, long-term investment strategy and do not speculate on short-term price gains. For strategic reasons, they also hold instruments, such as funds with a look-through on a daily basis, in their portfolio. The new regulation would treat these institutions as trading-book institutions, even though there is no intention to trade.

We are therefore of the opinion that the intention to trade should be recognised as a main criterion for the allocation to the trading book.

IRB approach in credit risk

As soon as a bank applies an IRB approach for part of its investments within an asset class, it is expected that it extends this approach to all investments within this asset class. This new requirement by the Basel Committee with regard to the application of the IRB approach for credit risk (point 44) is expressly welcomed by the EBA (Policy Advice on the Basel III Reforms).

According to this requirement, institutions could in future, for each exposure class, choose whether they apply the IRB approach for the credit risk instead of the standardised approach, without the IRB approach in principle being applicable for a certain time period to all exposures of the institution – as hitherto pursuant to Article 148 CRR. In the absence of this provision, many specialised institutions and LSIs would already apply the IRB approach now because they have sufficient default data available and good internal rating and scoring procedures for their core portfolios.

On the basis of the new Basel regulation on partial use, these portfolios can be increasingly transferred to the IRB approach. The use of the IRB approach is known to lead to better lending standards and decisions, better pricing of the credit risks, appropriate risk provisioning and better risk management.

The present IRB users – due to the above-mentioned CRR provision – also use the IRB approach amongst other things for exposure classes which are not eminently suitable for this, for example

because they are very low risk and only a small amount of historical default information is available concerning them or because the introduction and operation of a rating are disproportionately costly here. Present IRB approach users should therefore also be able to use the facilitated partial use of the IRB approach.

However, the Basel Committee expects institutions that use the IRB approach for an exposure class "to continue to employ an IRB approach for that asset class. A voluntary return to the standardised approach … is permitted only in extraordinary circumstances…" (point 48). We welcome the Policy Advice of the EBA in this respect (recommendation CR-IR 3):

"The entry into force of the final Basel III framework should be considered as an extraordinary circumstance for reverting to less sophisticated approaches in order to ensure a level playing field for institutions and to avoid creating a last mover advantage with respect to the implementation of the IRB approach."

To avoid early users of the IRB approach being placed in a less favourable position, we consider it necessary for institutions in future, in agreement with the competent authority, to be able to remove individual exposure classes from application of the IRB approach. The conditions for reverting to less sophisticated approaches pursuant to Article 149 CRR should be reformulated in accordance with the Basel requirement for partial use and be related to individual exposure classes.

Property valuation approach (whole loan versus loan splitting approach)

A quantitative impact assessment among selected EFBS members ascertained that the relative costs and benefits of the LS approach and the WL approach are very similar. Specifically:

- We conclude that the necessary operating expenditure for implementation will turn out to be approximately the same under both approaches. In the light of this, there is therefore no uniform preference in favour of one approach or the other from the point of view of the institution.
- We find that the RWAs determined also depend very little on the chosen approach. We also find that neither the LS nor the WL approach can be considered universally advantageous/disadvantageous for all institutions. Which approach entails a (slight) advantage for institutions in the end depends on the LTV ratio of the individual institution. From the point of view of the credit sector, there is accordingly no uniform preference for one approach or the other.
- To the best of our knowledge, both approaches show comparable risk-sensitivity.

Due to the different portfolio structures of institutions, in our opinion a whole loan approach to property collateral is not appropriate. A right to choose should be made possible at institution level in order to adapt the capital charge to the respective portfolio structure. The choice of approach should be permanent and made transparent through disclosure.

Should you require further information concerning the issues stated above please do not hesitate to contact us.