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) 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 housing savings institutions/ 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 mostly 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 banking 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. In addition, strict regulations apply to the granting of loans and the associated valuation of collateral. For example, Bausparkassen are not allowed to use the market value of the property as a basis, but rather the value that can be achieved on a sustainable basis as the mortgage lending value (Beleihungswert). Maximum lending is limited to 80% or 100% (under certain conditions) of the calculated mortgage lending value.

The Basel standards constitute homogeneous rules for all institutions regardless of their size or their business model. 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 specialised credit institutions with a simple and non-complex business model, such as the Bausparkassen one, should be avoided. For the EFBS the following points are in particular relevant.

1. Specific transitional arrangement for low-risk exposures secured by mortgages on residential property when calculating the output floor

First of all, the EFBS would like to make clear that the introduction of the output floor will severely impair the risk-adequate calculation of capital requirements for prudentially audited models that are certified by the respective competent supervisory authority, such as the models used by Bausparkassen. The risk profile of conservative business models, such as those of Bausparkassen, is not sufficiently taken into account and will be disadvantaged accordingly. In addition to these associated higher capital requirements, there are further operational expenses. Parallel to the internal risk model, a comparative calculation according to the standardised approach must be made on an ongoing basis. This must not only be taken into account in the field of reporting, but also in risk management, pricing and planning processes. The additional burden for the affected institutions is tremendous.

Furthermore, we point out that the burdens from the output floor for legally limited, conservative real estate financiers, such as Bausparkassen, are significantly higher than the benchmark set by policy makers. This leads to a considerable competitive disadvantage compared to other financiers on the market, e.g. non-banks active in real estate financing, for which no higher capital requirements are envisaged.

Against this background, we welcome the specific transitional provisions for low-risk exposures secured by mortgages on residential property when calculating the output floor as proposed by the European Commission in Article 465(5) CRR III. According to a first set of calculations, these provisions lead to appropriate relief in capital requirements for Bausparkassen[1]. However, these relief measures are limited in time and therefore not beneficial in the long run. **We therefore advocate for the introduction of permanent relief measures for low-risk exposures secured by mortgages on residential property.** <u>We believe that those arguments that lead to the temporary provisions hold also true for a permanent solution</u>: Bausparkassen can fulfil both the qualitative criteria set out in Article 465(5) CRR III and the quantitative criterion listed in the same article. The target value of **a maximum loss ratio of 0.25%** on a six-year average is clearly undercut by the Bausparkassen. **Due to the very favourable, i.e. low, loss history, the loss ratio of Bausparkassen is on average approximately 0.1%. Therefore, in our opinion Bausparkassen should also be granted the possibility to use the risk weights applicable according to Article 465(5) CRR III <u>on a permanent basis</u> when calculating the output floor. Furthermore, Bausparkassen which use the Credit Risk Standardised Approach (CR-SA) for the calculation of their credit risks should also be able to use the above-mentioned risk weights on a permanent basis, because the criteria are also complied with across the board.** No distinction should therefore be made between CR-SA and IRBA institutions to guarantee a regulatory level playing field.

We would also like to point out that, should the inappropriately high-risk weighting be intended by assumption of excessive price development and leverage, more suitable measures exist for

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[1] This shall be illustrated by means of an example calculation of a Bausparkasse. For this purpose, the risk weights for real estate loans calculated from certified IRBA risk models were compared with the envisaged CR-SA risk weights:

- average risk weight IRBA (actual): 15,5 %
- average risk weight CR-SA (art. 125): 36,5 %
- average risk weight CR-SA (art. 465 (5)): 24,99 %

counteracting it, such as LTV restrictions on lending or the introduction of selective capital buffer requirements.

In addition, we support the approach contained in Article 104a(6/7) of CRD VI to offset the mechanical Pillar II capital increases resulting from the full implementation of the output floor through corresponding reductions in the SREP add-ons.

2. 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 services component it contains. For the calculation of the services component, the maximum of fee income or fee expenses is taken into account (Article 314(3) CRR III). 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 requirements.

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 business models such as Bausparkassen one. 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 services component does not lead to a realistic risk assessment in the case of fee-based business models.

Actual operational risks regarding the services component for Bausparkassen result from claims and scenarios, in which Bausparkassen have to refund commissions. 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 services 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 services 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 services component. This example shows to what small extend the actual risk of Bausparkassen results from the commission system. The Basel design of the services 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 services 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.**

Therefore, Article 314(3) CRR should read:

"For the purposes of paragraph 1, the services component shall be calculated in accordance with the following formula: SC = max(OI, OE) + max(FI, FE) where: SC = the services component; […] FE = the fee and commission expenses component, which is the annual average over the previous three financial years of the institution's expenses paid for receiving advice and services, including outsourcing fees paid by the institution for the supply of financial services, but excluding outsourcing fees paid for the supply of non-financial services. ***When calculating the SC, institutions may exclude fees collected in connection with the conclusion of a transaction giving access to contractual savings schemes leading to a mortgage loan with fixed interest rates and which fees' are passed through to the sales force as acquisition costs immediately after they have been settled."***

The Internal Loss Multiplier (ILM)

In the past, the EFBS had welcomed the initiative of the Basel Committee on Banking Supervision 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. This being said, the Internal Loss Multiplier (ILM) is an appropriate instrument to calculate the requirements which can lead to alleviations, if the ILM is smaller than 1. The active use of the ILM describes in our opinion a suitable tool and incentive for well-balanced business model, such as the Bausparkassen one. Its application leads to adjustments regarding regulatory capital in the field of operational risk when being justified by historically low loss data.

Therefore, we regret the decision of the European Commission in its proposal for Article 312 CRR III to have opted for the option embedded in the final Basel III standards to set the ILM equal to 1 and therefore not taking into account the loss history of an institution. While the Commission argues that "*for the calculation of the minimum own funds requirements, in order to ensure a level playing field within the Union and to simplify the calculation of operational risk capital, those [Basel] discretions are exercised in a harmonised manner by disregarding historical operational loss data for all institutions*" we argue against it by saying that the system loses risk sensitivity by the Commission's decision and therefore is counterproductive compared with other parts of the legislative proposal, e.g. in the field of credit risk, where more risk sensitivity is a central objective of the adjustments proposed by the European Commission.

Therefore, the EFBS continues to argue for an ILM, which can be lower than 1 for all business indictor buckets listed in Article 313 CRR III.

3. 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). In its legislative proposal on the transposition of the final Basel III standards into European law, the European Commission stats that "*an institution may assign to the non-trading book a position […] where the institution has proven to the authority's satisfaction that the position is not held with trading intent […].*"

The EFBS strongly welcomes this new provision since "the intention not to trade" was requested as an allocation criterium as non-trading book position for a long time. Without the new provision, many institutions, which are non trading-book institutions and have no intention to trade, would have become trading-book institutions. 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 provisions now provide for the possibility to treat these instruments as non-trading-book instruments.

4. IRB approach for credit risk

Partial use of IRBA

According to the BCBS-requirement, institutions can in future choose for each exposure class, 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.

On the basis of the new BCBS-requirement 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.

In this context, we welcome the approach of the European Commission in its current legislative proposal that *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*.

In addition, we welcome the possibility foreseen in Article 494d CRR III that *by way of derogation form Article 149, paragraphs 1, 2 and 3, an institution may […] revert to the standardized Approach for one or more of the exposure classes provided for in Article 147(2) […].* **However, we would like to stress that the foreseen time period for this provision (1 January 2025 until 31 December 2027) is chosen too inflexible. A return to the standardised approach should be possible as soon as the final legal text is published in the Official Journal of the European Union. This would allow to return to the standardised approach sufficiently timely to avoid future calculations of the output floor for IRBA portfolios which will be required as of 1 January 2025.**

As mentioned above, in our opinion it is appropriate to no longer require an IRBA coverage ratio that comprises the entire portfolio. **However, we would like to ask for further clarification that also sub-portfolios, which may not fall under the concept of immateriality ["*exposures […] immaterial in terms of size and perceived risk profile*", Article 150(a) CRR III], can also remain in the standardised approach in certain cases. As an example, we would like to mention sub-portfolios of foreign branches for which the implementation of IRBA-compliant models, processes and systems does not appear appropriate from a cost/benefit perspective.**

<u>Input Floors within the IRBA</u>

Especially due to the collateral-specific input floors and the required comparative calculation for those parts of a loan that are secured by guarantees, the EFBS sees major challenges for modelling and reporting. If an institution uses a loss estimation model, complex challenges arise for further processing. For example, it is difficult to figure out the minimum level of the parameters and the risk weight from the required RW floor for guarantees. As a result, in our understanding, the requirements force institutions to estimate recovery rates at collateral level for mixed collateral and thus have to assign multiple parameters for mixed collateral. Especially with regard to transparency and data quality, the new requirements seem to be questionable. Moreover, the complexity resulting from these requirements could lead to disincentives for institutions. In order to avoid expenses, valuable collateral could be omitted from the parameter forecast and consequently from the capital backing. Under certain circumstances, this could even lead to lower capital requirements than with the calculated application of the RW floor or the minimum LGDs.

National specificities with regard to a narrow or larger security purpose statement are not taken into account neither. In any case, the provisions proposed by the European Commission will lead to capital requirements higher than the actual observed losses. Such a setting must be avoided.

We also point out that the RW floor for guarantees does not sufficiently take into account the contract constellation. Assigning the guarantor a risk weight analogous to the direct portfolio does not take into account the fact that the guarantor is only made use of in the event of a default of the actual debtor.

Last but not least, we would like to point out that all internally used parameter models have been intensively audited and finally certified by the responsible supervisory authority, which raises the question of the necessity of floor specifications.

In this context, we call for input floor requirements to be dispensed as far as possible and for adequate and, above all, transparent regulations.