



Brussels, 11 September 2015

**Comments by European Federation of Building Societies on the consultative document
"Interest rate risk in the banking book" (BCBS 319)**

The European Federation of Building Societies (EFBS) welcomes the opportunity to participate in the consultation organised by the Basel Committee on Banking Supervision on "Interest rate risk in the banking book".

The 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 European Union Member States. 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. Interest rates on savings and loans in the context of Bausparen 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 new tariffs or new products on the market. As part of this product testing, Bausparkassen must prove the sustainability of their products and tariffs.

The EFBS would like to comment on several elements of the consultative document "Interest rate risk in the banking book" in the following manner:

I. General comments

We largely agree with the comments made by the German Banking Industry Committee on the Basel Committee's consultative document. We share their view that the original objectives pursued by the Basel Committee will not be achieved by the implementation of the methodology set forth in this consultative document. This holds true in particular for German Bausparkassen.

The interest rate risk in the banking book of German Bausparkassen is being measured today by means of sophisticated internal models which have gained approval by regulators, at the time of implementation and again in recent years. Resulting risk positions are covered by capital following standard ICAAP methodology to ensure sufficient risk-bearing capacity at all times. These internal

models take into account the idiosyncratic product properties of a "Bausparvertrag", embedded customer optionalities as well as current and future yield curve scenarios.

Because of its idiosyncratic product properties and a specific legal framework in Germany for suchlike contracts, the implementation of a standardised risk-measurement approach similar to an approach for classic savings and sight deposits can lead to results not intended by regulators. In particular, the separation of the Bausparvertrag in a standardised "loan leg" and a standardised "savings leg" and its ensuing classification in otherwise standardised product categories, which negate the legal and contractual correlation between these two "legs", will – in most instances – not only lead to inadequate risk measures but could also result in a significant increase of the overall risk-position, if German Bausparkassen would be managed according to what the proposed regulatory measures in the consultative document indicate.

The recently published draft of the amended legal framework for German Bausparkassen ("BspkG") further demonstrates that the specific management of Bausparkassen by sophisticated internal models is pivotal and the amended legal framework includes extended and detailed regulations with respect to e.g. product approval processes, regular long-term ("kollektiver Lagebericht") and ad-hoc reporting requirement, all based on those internal models.

The comments made by the German Banking Industry Committee have already captured the fundamental problems of the proposed standard approach as it is put forward by the Basel Committee. Herewith, we will thus focus on additional problems with the Committee's suggested standard approach that result from the idiosyncrasies of the German Bausparvertrag. The following paragraphs outline why the German Bausparvertrag should be treated differently from other products that can be found at banks' balance sheets:

II. Specific comments relating to the business model "Bausparen" in Germany

(a) Particularities of the business model

Unlike other business models in the banking sector, the business model of Bausparkassen is based on a combination of a savings contract and a subsequent loan contract. Hence, the life-cycle of typical contracts of Bausparkassen (i.e. "Bausparverträge") combines – even contractually link - the characteristics of liability-type and asset-type products. In line with legal requirements, refinancing of current Bauspar-related loans is always to be secured by Bauspar-related deposits. Under Section 1 of Germany's Bausparkassen Act, Bausparkassen are "credit institutions whose business objective is to accept deposits from customers and to grant loans from these aggregate savings to customers for housing finance activities". Terms and conditions for both, loan and savings period, are fixed at the time when the contract is concluded. These terms and conditions are subject to (pre-)approval by the German supervisor.

The aggregate of outstanding loans and collected savings deposits under current Bausparverträge is of long lasting nature and bears no explicit maturity. When Bausparkassen apply for supervisory

approval of any new type of Bauspar-related product (typically called new tariff class), which is mandatory under German legislation, they have to prove – via extensive and explicit simulations – that the underwriting of new loans and new deposit collection (resulting from this new tariff class) are aligned and do not endanger the sustainability of the institution. Thus both, the business model and specific supervisory regulation, distinguish Bausparkassen fundamentally from a universal or retail bank's general lending and deposit collection business. At the latter institutions, there does not exist a legal link between saving and lending processes. To honour the idiosyncratic product properties of German Bausparverträge, the Bausparkassen have developed collective valuation and simulation models and mechanisms to ensure the liquidity and solvability of their institution at any time. These models, which are approved by German regulators, show that a joint assessment of the savings and loan phases is imperative to capture the risk and return profile of a German Bausparkasse.

The effects of changes in interest rates on the specific business model of German Bausparkassen are analysed in the so-called "kollektivem Lagebericht" which the institutions regularly have to submit to the German supervisor. The report itself presents the inherent interest rate risks in a transparent manner to the supervisor. In this context, special consideration is given to the specific characteristics of the Bausparvertrag with its savings and loan phase and embedded customer optionalities.

(b) Process for slotting and decomposing banking book instruments

Because of its idiosyncratic nature, the German Bausparvertrag does not fit into any of the categories listed in the consultative document. Neither savings deposits nor loans under regular contracts issued by Bausparkassen have standardised cash flows. While fixed interest rates are agreed upon – as described above – for the saving's and loan's phase when the contract is concluded, optionalities exist on behalf of the customer, when it comes to the rate of deposit collection or instalment payments on the loan side of the agreement. Notably, Bausparverträge are not entered into for an indefinite period, but have a defined standard savings plan and a defined target date (between five and fifteen years, depending on the home savings plan). While early termination of the contract is possible in principle, it is not significantly interest-driven for several reasons – as explained later – and is inhibited by a variety of mechanisms which are specific to the underlying contract mechanisms.

Bausparkassen therefore use internally developed, sophisticated forecasting techniques to predict the future development of the loan and deposit side as precisely as possible. These forecasts provide important findings that help them to take decisions on general business policy and interest rate risk management techniques. Today's methods and models, which have been approved by the German supervisor, enable Bausparkassen to describe trends in their portfolios of savings deposits and loans, whilst taking into consideration customer behaviour. The "kollektiver Lagebericht", the regular approval process of the German regulator for new products issued by Bausparkassen as well as regular stress tests carried out by the German supervisor to establish the interest rate risk for Bausparkassen are based on these techniques. Therefore, it stands to reason that they should also be used as the basis for managing the interest rate risk position of German Bausparkassen.

Due to the particularities of the underlying product, the cash flows currently used to measure the present value of the interest rate risk for Bausparkassen are also established by means of these internal models. Defining standardised processes and factors would lead to unrealistic cash flows and flawed management decisions because such standardised processes and factors fail to reflect the behaviour of the customers of Bausparkassen. For this reason, the cash flows should continue to be established on the basis of internal models.

To better demonstrate the improper mapping of risks and the possibly resulting management mistakes due to the separation of savings deposits from loans granted under Bausparverträge, the following paragraphs will describe the effects which would be caused if these savings deposits (i.e. Bauspareinlagen) were classified under the category “non-maturity deposits”.

(c) Treatment of Bauspareinlagen as non-maturity deposits (NMDs)

Unlike conventional/traditional savings deposits, balances on Bausparverträge do not have variable, but fixed interest rates, and their maturity is generally limited. Under Germany’s Bausparkassen Act, Bausparkassen are not allowed to guarantee a certain maturity date. However, they forecast a maturity date when a Bausparvertrag is concluded. In principle, customers can terminate their home savings accounts during the savings phase. In this case, however, they will lose not only the option for a relatively low-interest loan but also the upfront fee paid upon conclusion of the contract, as well as bonuses paid by the Bausparkasse and public funding granted to support long-term savings. Against this background, empirical evidence over various interest rate cycles has shown that cases of early termination of Bausparverträge are (extremely) rare – even when interest rates increase – and has demonstrated that there is no significant correlation between early contract termination and the yield curve. For these reasons alone, it is inappropriate to categorise balances on Bausparverträge as NMDs.

If balances on Bausparverträge are nevertheless included in the category of “non-maturity deposits” because of their unclear definition, the standardised approach would lead to a much shorter assumed maturity as is economically viable – i.e. 49 percent would have to be assumed to be payable on demand. This would lead to a completely exaggerated interest rate risk position that does not exist in reality. In turn, applying the suggested methodology would mean that the interest rate risk position in the banking book of German Bausparkassen would artificially be increased by a multiple of today’s value. This has been demonstrated by preliminary simulations calculated by the Bausparkassen on the basis of the QIS – as published by the Basel Committee.

If Bausparkassen try to reduce the risk position as established by the proposed new Basel methodology (in order to preserve their current capital ratios under ICAAP), they would – contrary to supervisory intentions – create open risk positions. Currently, Bausparkassen are largely hedged against interest rate shifts from both, an economic and an earnings perspective, by investing currently unused liquidity in securities creating a balance between reinvestment risk, market risk and P&L-volatility. Extensive simulations show the robustness and (interest rate) risk-reducing qualities of these investment strategies. The newly proposed Basel regulation would lead to a significant

shortening of the maturities of aforementioned securities – either by sale and re-investment operations or swap transactions. The banking book position would thus become rather vulnerable to prolonged periods of low yields while flourishing in case of a speedy yield hike – in any case interest rate risk insulation would be given up in favour of positioning Bausparkassen one-sided against yield hikes. Ultimately, the sustainability of Bausparkassen would become severely dependent on yield curve shifts, destabilising an otherwise robust business model in the future, and further jeopardising its resilience against stress scenarios.

After demonstrating that it is not appropriate to classify balances on Bauspar accounts in the category of “non-maturity deposits”, the following paragraphs will show that treating balances on Bauspar accounts as “term deposits subject to early redemption risk” will also map risks incorrectly.

(d) Treatment of positions with behavioural options other than NMDs

Unlike traditional fixed-rate term deposits of banks, balances on home savings accounts are regularly accumulated during the savings phase. Although the maturity date of the home savings deposits is generally planned, it can be influenced by savers both by varying the rate of savings and by not withdrawing their deposits. While, in principle, savers can terminate their Bausparverträge, the termination of accounts is not strongly influenced by current interest rate levels. Instead, it is driven by other factors such as an individual’s liquidity needs or the agreed interest rate on loans.

Due to the system of incentives described above (potential loss of entitlement to the corresponding mortgage loan, of the upfront fee, and of bonuses and public grants), Bausparkassen have not observed a significant correlation between the termination of Bausparverträge and interest rate levels in their portfolios. Classifying balances on Bausparverträge as “term deposits subject to early redemption risk” and the associated application of predefined scalars therefore leads to an incorrect and exaggerated presentation of the interest rate risk position. Because the rates of account termination specified for the stress scenarios in the standardised approach set out in the Basel Committee’s consultative document exceed the rates of Bausparvertrag termination observed in practice by a multiple.

(e) EVE measure

The calculation of the capital requirements is centred around the economic value of equity (EVE), which is a static model that measures the theoretical change in the net present value of interest-bearing assets and liabilities between a base scenario and a stress scenario. The accuracy of the valuation by means of a net present value model very much depends on the underlying cash flows and the discount factors applied. As shown above, classifying balances on Bausparverträge in the standardised categories specified in the consultative document (NMDs, term deposits) will lead to an incorrect calculation of cash flows. Consequently, the various stress scenarios lead to present value losses which are unreasonably high and may even misrepresent the risk altogether.

In addition, one general drawback of the static present value model is that cash flow optionality (i.e. changes in cash flows due to changes in the yield scenario) are not adequately covered. To eliminate this drawback, the cash flow defined in the BCBS standardised approach is modified, depending on the stress scenario involved, to allow for optionality. However, the optionality stipulated in the BCBS standardised approach does not fully cover the customer options embedded in the German Bausparvertrag, or only in a distorted manner. In addition, there is empirical evidence which demonstrates that the behaviour shown by customers of German Bausparkassen with regard to exercising the contract-inherent optionality significantly differs from the behaviour assumed in the BCBS standardised approach. For this reason, the computation of the present value as set out in the proposed standardised approach does not correctly reflect the value and risk of the options inherent in German Bausparverträge. Consequently, the interest rate risk determined on the basis of the suggested Basel methodology is inaccurate.

The fair values on which the static present value model is based imply that the net cash flows are closed out at market interest rates as of the reporting date. In German Bausparkassen, however, assets – i.e. mortgage loans – are largely refinanced by current or future savings deposits, instead of being refinanced via the capital market. Hence, refinancing a German Bausparkasse is not directly subjected to fluctuations in the capital market. In addition, Bausparkassen have various management mechanisms (e.g. design of contracts, valuation index, termination (blocking) periods) at their disposal – some of which are prescribed by law – to control the loan to deposit ratio of their portfolio.

For the reasons cited above and in view of the long-term business model, the interest rate risk exposure of the banking book of Bausparkassen cannot be accurately determined by means of the static present value approach as proposed by the BCBS. Therefore, Bausparkassen have developed elaborate dynamic simulation models upon which they base their management decisions with regard to interest rate risk positioning. Due to the idiosyncrasy of the underlying business models and contracts, the application of simplistic or standardised static risk modelling approaches would lead to significant management errors. Collective refinancing mechanisms would be negated whilst cash flows would be inappropriately modelled.

(f) Earnings-based measures

We fully support the criticism expressed by the German Banking Industry Committee with regard to the highly simplified and static earnings-based measures (NII approach). In addition, the Bausparkassen would emphasise that the suggested NII approach is also a static method which is based on the same cash flow as the EVE approach. Hence, the points outlined before with reference to the EVE approach apply equally to the NII approach. Once again, the assumption that cash flow gaps will have to be closed by offsetting capital market transactions is not compatible with the practice of Bausparkassen which are fulfilling their refinancing requirements almost entirely from current and future savings deposits that are collected at fixed interest rates, so that their interest rate sensitivity is negligible.

In principle, Bausparkassen welcome the use of a net-interest-income-based approach to measure the interest rate risk. However, this approach should also include the simulation of trends in the current business and in new business, i.e. it should be dynamic. Bausparkassen already use highly sophisticated internal simulation models which provide sufficiently reliable forecasts of net interest income over the next few years, taking into account the expected future development of the business, anticipated customer behaviour and the assumed process of interest rates. These models are regularly validated, audited and tested by the German supervisor and are one basis for the "kollektiver Lagebericht", which is regularly submitted to the supervisory authority.

(g) Minimum capital requirements

In principle, we welcome the fact that it is also made possible to determine minimum capital requirements by means of a net-interest-income-based approach. However, because of the problems described above with regard to both the EVE approach and the NII approach, we believe that determining minimum capital requirements by means of these two approaches – regardless of the options proposed – is not suitable for Bausparkassen.

In addition, first model calculations have shown that the minimum capital requirements are dominated by the calculated present value loss. This is due to the specific business model of Bausparkassen and the underlying bias of this risk measure as outlined before. Hence, the determination of minimum capital requirements will exclusively be focused on the EVE approach which, as explained above, leads to an overstated interest rate risk for Bausparkassen and, eventually, to risk management errors. Relying only on a single indicator is also not compatible with the comments made in the EBA Guidelines on the management of interest rate risk arising from non-trading activities (EBA/GL/2015/08) published in May this year. Here, it is recommended that a broad spectrum of instruments should be applied to measure the interest rate risk as a function of the institutions' business model.

(h) Rules/Guidelines – Principle 8

Like the German Banking Industry Committee, we are also strongly opposing the publication of the computed results of the fallback solution because, as described above, the current version of these computations does not adequately reflect the interest rate risk of Bausparkassen and provides a wrong perception. Furthermore, we are strongly opposing to the publication of the chosen parameters and model assumptions for competitive reasons.

III. Conclusion

In agreement with the German Banking Industry Committee, we take the view that the standardised approach as defined by the supervisor to determine the interest rate risk in the banking book in order to identify minimum capital requirements is not effective, and hence, not necessary. We believe that the specific business models of banks will have to be taken into consideration when designing an adequate interest rate risk management system to ensure that the interest rate risk is measured accurately and to facilitate appropriate management of aforesaid risk. In view of the detrimental consequences of the consultative document BCBS 319 for both, the Bausparkassen industry as a whole and individual institutions alike, it is therefore urgently recommended to find more adequate forms of capturing the interest rate risk in the banking book in a format that can efficiently and effectively monitored and controlled by supervisors.