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UEPC opinion on the 3rd consultative paper of the Basle Committee on Banking Supervision regarding Capital Adequacy of Risk-bearing Assets of Banks ("Basle II") as of April 2003

1. Improvement on 2nd consultative paper of January 2001 from the point of view of the real estate trade

With its decisions of 10 July 2002 the Basle Committee introduced decisive improvements to the 2nd consultative paper, which are of great importance to the real estate sector. These are detailed in the 3rd consultative paper. The most important improvements concern the following points:

- Private housing loans are assigned to the retail sector, basically involving a pool assessment of the credit risks in the different credit portfolios. The additional risk premiums linked to a loan's remaining term are therefore now superfluous. For the other sub-categories in the retail sector, the loans from an institution to a single person in a specific 'sub-portfolio' are limited to 100,000 euros. The only exception are housing loans, where a limit on the size of loan does not determine allocation to the retail sector (paragraph 199)[1]. Investments in multi-storey apartments may also benefit from being assigned to the retail sector. In this case the Basle Committee leaves it up to national supervisory authorities to decide how many apartment units in a multi-storey block may be funded by one person through a single credit institution (paragraph 199).

- Small businesses may also be allocated to the retail sector, as long as they have not subscribed to external funding of over 1 million euros (paragraph 200).

[1] The paragraph numbers refer to sections in the 3rd consultative paper unless otherwise indicated.

- In practice, difficulties in implementation could be caused by the most important aspect of the retail sector, i.e. that credit risks do not depend on the term of a loan. This is because this feature is being extended to ‘medium-sized’ firms, even though the individual assessments of loans as to the soundness of the debtor and the risks of the individual commitment will continue.

- The cut-off point for a medium-sized firm is 500 million euros, applicable to both the balance sheet total and the proceeds from turnover. This puts capital-intensive investments at a disadvantage, i.e. the very sort of investment common throughout the real estate sector. Depending on the items recorded, in the real estate sector the balance sheet total regularly amounts to six to ten times the proceeds from turnover. In the company group the maximum value of 500 million euros for both reference numbers refers to the fully consolidated annual accounts (compare all paragraph 289).

- The third impact study (QIS 3), which was started in October 2002 on the basis of the decisions of 10 July 2002 following the changes made after the tabling of the 2nd consultative paper, has led to an arithmetic transfer in the 3rd consultative paper for loans granted to small and medium-sized enterprises (SMEs). They move from the retail sector into the company loan category. This is the result of a correlation between size of loan and the risk weighting in a specific loan portfolio. From 5 million euros to 50 million euros total credit the value for the correlation between the probability of default by the debtor (PD) and the loss to the bank in the event of default by the debtor from a loan transaction (LGD) is illustrated by a ‘correlation curve’. The more loan funding a company receives, the less ‘flat’ the curve appears (“displacement of function to the left”) – compare paragraph 242.

- The Basle Committee has given the national supervisory authorities the option to treat special loans (SL) as company loans. This mainly affects project loans and tenement housing where loan eligibility depends on the cash flow which is linked to a business asset. The 3rd consultative paper now explains that the supervisory authorities may also grant permission only for individual sub-categories of special loans (paragraph 231).

An extremely important decision in the 3rd consultative paper for the real estate trade which came about following the third impact study is the broad similarity between standard evaluation procedures for assessing loan risks based on external ratings

and the internal IRB banking approach, based on the bank's own estimate of at least the likelihood of a debtor defaulting. For real estate investments this becomes particularly noticeable in the case of collateral, as soon as 100% of the first section over the loan value is secured by real estate. Here the Basle Committee lowered the risk-bearing proportion of the loan from 45% in the 2nd consultative paper to 35% in the 3rd consultative paper (compare paragraph 260f, note 64). However, this only applies to housing, not to commercial buildings. In the latter case, the reduction in the risk-bearing proportion of a loan achieved through collateral in a form other than recognized physical collateral would change from 50 to 45% (paragraph 260f, note 64). Both procedures to assess loan risk, where the bank decides on the debtor's probability of defaulting either using external ratings or its own statistical surveys, converge on 'Cap 4%', on condition that the lack of an external rating in the standard procedure can lead to the choice of a 100% risk weighting, with the permission of the relevant supervisory authority. Moreover, a bank may - to different degrees - employ estimates of risk measurement parameters stipulated by the supervisory authorities for the individual sub-categories, particularly LGDs as they correlate to the likelihood of debtor default (paragraph 231).

2. Unresolved problems of real estate loans and providing collateral for loans in the form of real estate (3rd consultative paper), following the decisions of 10 July 2002 amending the 2nd consultative paper

The decisions of the Basle Committee meeting of 10 July 2002 suddenly improved the conditions for real estate loans and for loans with collateral provided in the form of real estate as part of the capital adequacy requirements for bank loans. It therefore seemed as though only two problems remained with as yet no satisfactory solution:

- **No allowances made for general or specific risk premiums on capital adequacy for real estate loans**

  The decisions of 10 July 2002 stipulated that the retail sector should be split into three parts: real estate loans, 'qualified' loans repayable by instalments and 'other retail sector loans'. The second sub-category, 'qualified instalment loans', stipulates the prior condition that an individual must not have borrowed more than 100,000 euros in a 'sub-portfolio' with the credit institution. However, as a result of the risk premiums and bank fees which are constantly building up due to the instalments, at some point the remaining credit itself is exceeded (paragraph 202. To compare calculations see also paragraph 342 and following). The 'other' retail sector is only distinguished by the fact that on the one hand a loan taken out is not a ‘qualified’ instalment-type loan and on the other hand not a real estate loan either. The most important examples are credit card re-payments. Real estate loans would now have to ensure that the correlation between the remaining loan and the (0.15) LGD remains fixed. In the case of the other two sub-categories of the retail sector however, it decreases exponentially (paragraph 299, paragraph 301).

The Basle Committee has never tried to justify this since its attempt to establish various correlations between LGD and remaining credit in the retail sector in the ‘Potential Modifications to the Committee Proposals’ of 5 November 2001. It can only be assumed that the margins for real estate loans are deemed to be so small, that there is no room for manoeuvre left to cover general credit risks. In practice this introduces into the retail sector the risk components which depend on the loan’s remaining maturity. But the banking statistics tell a different story. The mortgage failure rate is so small that in the self-contained risk assessment model, which has to work for two years without any instructions from the banking supervisory authorities, the Basle Committee has to set a limit on the risk-bearing proportion of real estate loans of at least 10% for a transitional period (paragraph 235). However the 35% for first-rank loan components with full collateral should still be seen as too high both in the standard procedure based on external ratings and in the simple IRB approach. It should be born in mind that a shift between the correlation function for the ‘qualified’ instalment loans and the functions for the ‘other’ retail sector cannot be linked to the originally standard ‘other’ retail sector function. Moreover the Basle documents claim no empirical basis for this.

<u>UEPC demands</u>

The general loan risk should be compensated by risk buffers in general risk premiums for real estate too. It would also appear that the financial preconditions pertaining to the credit risks of real estate loans in the retail sector do not differ from those in the other retail sector. So within the sub-category for real estate loans in the retail sector, at least the transferability of proven excess risk buffers from special premiums, i.e. those that cover market-specific risks, should also be available for use as bank capital adequacy. This would make the mass business of many banks available for risk coverage of other loan classifications, beyond the retail sector (paragraph 347).

- **Restrictions to company loans for 'medium-sized' firms when additional risk premiums linked to length of term are forfeited**

  As a result of long negotiations the Basle Committee achieved success for companies that do not usually have the opportunity of attracting capital for their investments in ways other than bank loans. The committee managed to free them from the banks' risk premiums linked to the period of the necessarily long-term loans they contract. This genuinely lightens the burden of medium-sized businesses, and aims at ensuring a non-discriminatory application of the Basle rules given the different circumstances in the USA and UK on the one hand and in the rest of the European economic area on the other.

  This restriction will not exist for real-estate businesses if – as decided by the Basle Committee – the upper limit for the proceeds from turnover and for the balance sheet total is fixed at a single figure of 500 million euros. The table below is based on a survey done by the German association among one hundred of its member companies, which were of a relevant size. It shows that the ratio between the proceeds from turnover and the balance sheet total depends to a large degree on the type of property being sold.

  Any major discrepancy between turnover proceeds and balance sheet total is of course a sign of relatively weak profits. But that does not automatically mean a higher loan risk. It is more a question of commercial buildings entailing higher profit risks and therefore also higher loan risks than housing, and here the Basle Committee agrees. However, it appears to be the housing industry that is disadvantaged by a standard upper limit for turnover proceeds and balance sheet total.

Main business activity	Ratio turnover: balance sheet total	Comments
Manages almost exclusively rented accommodation	1 : 8 to 1 : 10	Depends on proportion of older property

Manages both rented accommodation and commercial space, often with construction work in the company group	1 : 3 to 1 : 4	Depends on ratio of housing and commercial space
Development and supply of housing and commercial buildings for the purpose of sale, often in a company group managing rented accommodation and commercial space	1 : 2 to 1 : 3	Depends on state of building industry and stock of land

UEPC demands

Turnover proceeds and balance sheet total should be alternatives, i.e. one or the other and not both at once. Should the Basle Committee reject this, perhaps at least a multiple of the turnover proceeds, at least five times the amount, could be used as a cut-off point for the balance sheet total as applied to medium-sized companies. In this case the benefit applies exclusively to credit risks dependent on remaining loan terms. Otherwise an individual loan assessment is required when the turnover exceeds 50 million.

3. New problems in the Basle rules from the point of view of the real estate trade as a result of the changes in the 3rd consultative paper.

The assessment of loan risks according to the standard procedure as opposed to the IRB simple approach using the bank's own statistics, together with the discussions about taking physical security into account, forged the public image of the 2nd consultative paper. As shown, in the view of the real estate trade the tensions in these areas have now been overcome as a result of the 3rd paper with the exception of a few residual problems. However, the main changes in the 3rd consultative paper as compared with the 2nd consist in the fact that as a standard for the banking supervisory authorities it now has far more of a legislative function. Above all there are major differences in the way the refinancing of banks has been included in the approach to loan risks and the reduction of those risks. The multitude of techniques with repo-style transactions, hedges and the separate risk assessment of unused credit lines demonstrates that full compliance with Basle II requirements using stochastic risk models is only going to be achieved by a few, very big banks.

Compared to the progress of the decisions of July 10 2002, in the 3rd consultative paper much more emphasis is given to the fact that the special loans have not been fully incorporated into the company loans. This is because the inclusion of the special loans in the credit rules for company loans was painstakingly negotiated. As a result it must now be clarified what powers the national supervisory authorities have if they assume that all or some of the special loans involve divergent higher risks than company loans. The 'special loan' categories unnecessarily burden the risk models for the implementation of the Basle rules.

- **Maintenance of the special loan categories**

  Special reservations in the rules on banking supervision have lead to special loans not being fully incorporated into company loans, as is illustrated by the fact that from the outset there have been no fewer than five sub-categories (paragraph 188). Compared to the 2nd consultative paper there is even a new sub-category for financing highly volatile commercial space (paragraph188).

  The next part will not deal with loans for projects, property or forward operations classified either as company or special loans (paragraph 189-193), but exclusively with the two real estate sub-categories of the special loans – Income-Producing Real Estate (IPRE) and High Volatility Commercial Real Estate. Both differ from company loans (provided a bank uses the special loan sub-categories or is forced to do so by the supervisory authority) in that the cash flow that is dependent on a business asset determines loan eligibility (paragraph 194). However, as these are classified as special loans they receive a higher risk weighting than is the case with company loans.

- **Permeability of the various procedures for assessing loan risks**

  The Basle Committee goes to great lengths throughout the 3rd consultative paper (unlike in the 2nd) to maintain the same risk assessments in the standard procedures based on external ratings and the simple IRB approach, where the bank does its own estimates sometimes based simply on the debtor's likelihood of defaulting. Even when the AMA (Advanced Measurement Approach) is used, based on complicated stochastic risk assessment models, the link with the risk measurement made using the simple IRB approach should be maintained. There is a basic IRB approach for special loans (paragraph 247), although external ratings could not then be applied to an Income Producing Real Estate project. However it is hard to see why investments which require a management with commercial expenditure, such as companies, will also not be able to be assessed using external ratings.

- **Inclusion of even highly volatile commercial property in the company loan category**

This is a newly created special loan sub-category in the 3rd consultative paper. This again raises the issue of the empirical gap in risk assessment, which determined risk assessment for special loans as a whole in the 2nd consultative paper. Banks still have no LGDs and EADs for highly volatile commercial space projects, and therefore must use the relevant formulas for company assessment (paragraph 253). This still fails to explain why the correlations for highly volatile commercial space projects are specifically defined, despite the fact the subtler risk weighting should produce advantages when providing loan collateral in the form of the necessary capital resources. It is also not entirely clear how such a function is to be copied from assessments using external ratings. This constitutes a double breach between the special loan and company loan categories, and between the approaches based on internal bank ratings and standard procedures based on external ones.

It is also worth noting that the national banking supervisory authority can in some cases decide to reduce high risks in the highly volatile commercial space projects to the proportions of normal special loans.

- **Insufficient attention paid to performance as collateral for project loans**

  Neither future use of the funds nor capitalised cash flow is recognised as collateral for special loans (paragraph 470). The company assessment standards offer no explanation of why these factors are excluded, whereas the flow rate of payments is indeed recognised as collateral in cases of identical risk structure.

- **Special rule for the management of rented accommodation by the state**

  Rented accommodation generally comes under special loans. The special rule for housing companies run by the state, in particular council housing, allows it to be classified with company loans (paragraph 470, note 83) and this constitutes unacceptable discrimination.

UEPC demands

As the discussions on sub-categories of credit risks and on the once controversial point regarding recognition of physical collateral were still relatively open during the 2nd consultative paper, the cut-off point for special loans could still be seen as a helpful part of the different procedures for assessing credit risks. Since then it has become clear that there is no single 'model' for assessing credit risks in the five special loan sub-categories. The business sectors of banks do not even overlap in practice. There are also insoluble problems because the dividing line has to be found not only for company loans but also for loans in the retail sector (compare multi-storey housing in paragraph 199). This is why UEPC is against the standardisation by bank supervisory authorities of special loan sub-categories and any other system of options in the Basle rules. Instead they should be a compulsory part of the risk assessment for company loans.

- **Difficulties in integrating the new sub-category of highly volatile commercial space projects into the special loans**

  Note that in the case of economically well-prepared investments with a high yield expectation (BBB - or better, + 25%; good BB, + or BB + 25%; satisfactory BB – or B+, + 25%) the new sub-category of special loans in the 3rd consultative paper again leads to much higher risks in the outstanding loan than is already the case with special loans (compare paragraph 249 with paragraph 244). A highly volatile commercial project therefore arises once an ADC investment (purchase of real estate or land for development, project development, construction) is made and the preliminary rent is not above the local market average. But this investment profile is particularly true of big projects developed over several years, and experience has shown the credit risk is no higher. The danger is that banks might start considering parts of projects, or periods of those projects, as highly volatile commercial space until the preliminary rent they deem necessary is attained.

UEPC demands

The new sub-category for special loan credit risks is therefore flawed, because it completely ignores management of the real estate, which is the fourth component in the course of an investment. Even developers whose field of activity is limited to the first three ADC steps, never lose sight of this management phase during their calculations. The UEPC therefore insists the new credit risk sub-category be dropped. If, as the UEPC demands, the special loan were seen generally as a company loan, the same would of course apply to the so-called highly volatile commercial space projects.

- **Pooling credit risk for loans in the retail sector**

Pooling credit risk is the typical relief measure for the retail sector, made possible by the multitude of loan facilities. However, the 3rd consultative paper once again clarifies the fact that use of a pool does not exclude individual assessment at certain risk management levels in banks (paragraph 196). All this means is that the banks are openly allowed the legal option of using bank supervision relief measures in the retail sector. However, they cannot create the corresponding transparency in their business policy from the pool by publishing the loan conditions (paragraph 200). A disadvantage of this is that a bank must cater for changes in its lending conduct during loan risk assessment (paragraph 411).

UEPC demands

A single method should be established for credit risk assessment in the retail sector and lending by banks. Use of the comprehensive facilities granted to the retail sector, freeing it from the errors inherent in individual assessment, should require banks to publish their lending conditions.

- **Simplified risk assessment for retail sector loans using the EAD models**

  The 3rd consultative paper includes a risk assessment facility, where banks may simply link the debtor's probability of defaulting (PD) with the remaining loan at the time of default (EAD). The more complicated LGD estimate is therefore unnecessary. The big disadvantage of this is that if the economy slows down there is no way of the banks calculating whether the new loans will fall faster than the LGDs will grow, or whether the opposite will occur. Based on previous models, and probably in the opinion of the Basle Committee too, it would nonetheless appear that with a predominance of short-term loans, the EADs drop faster, and in economic areas with mostly medium-term and long-term loans the opposite is true. The pro-cyclical effect of the new Basle rules is considerably enhanced in Europe in particular with the simplified EAD model. But the result would again be that the credit risk components dependent on the remaining term would be allocated to the retail sector.

UEPC demands

The UEPC calls upon the Basle Committee to reconsider the matter of authorising EAD models on the retail market. Small banks in particular are the main providers of funding for small and medium-sized companies which depend on the retail sector for loans. They would probably use these risk parameters as they are easier to handle and would then have to accept higher capital adequacy requirements, to the detriment of their customers.

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