



**VERBAND DEUTSCHER
PFANDBRIEFBANKEN**
Association of German Pfandbrief Banks

Comments

Basel Committee on Banking Supervision

Second consultative document

Revisions to the
Standardised Approach for credit risk

Contacts:

Eva-Maria Kienesberger

Telephone: +49 30 20915-530

Fax: +49 30 20915-55530

E-Mail: kienesberger@pfandbrief.de

Bastian Blasig

Telephone: +49 30 20915-560

Fax: +49 30 20915-55560

E-Mail: blasig@pfandbrief.de

Berlin, 11 March 2016

The Association of German Pfandbriefbanks (vdp) is one of the five leading associations of the German banking sector and a member of the German Banking Industry Association (“Die Deutsche Kreditwirtschaft”). It is the umbrella organisation of Germany’s Pfandbrief Banks, whose members and its affiliates are the foremost financiers for residential and commercial real estate as well as the state and its institutions. The vdp represents 40 Pfandbrief Banks with stand for around 97 per cent of all outstanding Pfandbriefe.

Response of the Association of German Pfandbrief Banks (vdp) to the Second Consultative Document on ‘Revisions to the Standardised Approach for Credit Risk’

vdp welcomes the opportunity to provide the Basel Committee with some specific comments on the proposals in the Second Consultative Document published on 10th December 2015.

Please note that we fully support the aim of the Basel Committee towards an efficient regime in those exposure classes where deficiencies have been discovered. We feel that the proposed concept is much more complicated than the present one, and that risk weights are inadequately increased. Therefore the Basel Committee’s objectives are being missed: simplicity, comparability, increasing risk sensitivity and not increasing capital requirements.

While the public debate about the proposal focused on the changes in all exposure classes, we would like to address some aspects in the proposed treatment of real estate lending.

Changing the treatment of mortgages in the ways discussed in the document could have wide reaching implications, as the ability to continue to lend to the real economy could be severely constrained.

1. Risk Weights

The risk weights for commercial real estate financing and cash flow dependent residential real estate financing suggested in the second consultation paper are much too high. As property markets in the individual member states of the Basel Committee develop differently and are unequally robust, it is not logical to apply excessively high risk weights also to well developed and long established real estate markets. The differences between the individual countries must certainly be taken into account, for example, national discretion could be included for jurisdictions where property markets and lending guidelines justify much lower risk weights.

The generally high risk weights contradict the statement by the Governors and Heads of Supervision (GHOS), which is explicitly reiterated in their press release dated 11th January 2016: *‘The GHOS will review the Committee’s proposals on the risk-weighted framework and the design and calibration of capital floors at or around the end of 2016. The Committee will conduct a quantitative impact assessment during the year. As a result of this assessment, the Committee will focus on not significantly increasing overall capital requirements.’*

The German real estate finance market for example is characterised by long-term loans and fixed interest rates compared to other markets. Since 1988 this stability has been regularly proven by its compliance with the maximum loss rates fixed by the Basel Committee. The analysis of loss rates amongst our member institutions also shows that significantly lower risk weights are appropriate for real estate financing in Germany. As part of the upcoming Quantitative Impact Assessment (QIS), we are of the opinion that it must be possible to demonstrate that the collateralised part of real estate exposures result in low loss rates.

With this in mind, we are of the opinion that the reduction of risk weights for residential and commercial real estate financing is essential.

2. Real Estate Loan Splitting

We define the term ‘real estate loan splitting’ as the theoretical split of a loan into a collateralised and a non-collateralised component. In Europe, this has so far been an essential element of the Standardised Approach for the real estate exposure class. We would definitely refrain from deviating from real estate loan splitting as described in footnote 44 of paragraph 52.

On the one hand the ‘real estate loan splitting’ is easy to avoid as two loans could be negotiated. However, this results in higher loan processing costs which would have to be paid by the borrowers. On the other hand, the real estate loan splitting results in a more accurate assessment of the credit risk and would in addition avoid any cliff effects, which are inherent in the concept of the consultative document.

We would like to show the cliff effects by way of an example of commercial real estate exposures:

Repayment is not materially dependent on cash flows generated by property			Repayment is materially dependent on cash flows generated by property			
	LTV ≤ 60%	LTV > 60%		LTV ≤ 60%	60% < LTV ≤ 60%	LTV > 60%
Risk weight	Min (60%, RW of Counterparty)	RW of Counterparty	Risk weight	80%	100%	130%

Commercial real estate financing A

Value of the property100

Loan60

LTV ratio60%

Commercial real estate financing B

Value of the property100

Loan61

LTV ratio61%

Commercial real estate financing A

Value of the property100

Loan80

LTV ratio80%

Commercial real estate financing B

Value of the property100

Loan81

LTV ratio81%

Comparison between RWA with loan splitting

EaD	RW	RWA
60	60%	36
		36

RWA increase of 1

Comparison between RWA with loan splitting

EaD	RW	RWA
80	80%	48
		48

RWA increase of 1

Comparison between RWA without loan splitting

EaD	RW	RWA
60	60%	36
		36

RWA increase of 25

Comparison between RWA without loan splitting

EaD	RW	RWA
61	100%	61
		61

RWA increase of 13

The increase of the loan by EUR 1 can result in a disproportionate rise in capital requirement if it exceeds the LTV limit.

In principle, there is no requirement to create different LTV buckets. Even in the case of real estate loan splitting, every increase in the loan results in an increase in total risk weight. But the usage of only one LTV bucket has the advantage that collateral agreements can be better linked to the loan where there is no one-to-one relationship between the property and the loan. Footnote 44 shows how the LTV is to be calculated if a property serves as collateral for several loans from one credit institution. However, it remains unclear what the procedure is when several properties secure a number of loans. The calculation of the LTV by simple addition of the loan amounts and property values results in an unrealistic high risk treatment, particularly if the properties also secure further loans taken out by the borrower (wide declaration of purpose).

We would therefore like to suggest to permit real estate loan splitting with the consequence of individual risk weights. In any case the number of LTV buckets for commercial real estate

exposures has to be aligned with the number of LTV buckets for residential real estate exposures.

3. Cash Flow Dependence

The division of the real estate exposures classes ‘residential’ and ‘commercial’ into ‘cash flow dependent’ and ‘non-cash flow dependent’ financing is something new. In terms of verifying the non-cash flow dependence, in the case of both residential and commercial real estate financing, it is necessary to ensure that the repayment of the loan is not significantly depending on the cash flow generated by the property serving as collateral for the loan. In future, with the exception of certain residential real estate financing, an individual statement of proof will have to be provided for every loan.

This not only results in significantly greater time and effort, it may also compromise loans which have been granted on the basis of robust lending guidelines but have low default rates. With this in mind, it should be considered whether to verify the non-cash flow dependence either at national market level or at the level of the individual credit institutions. In terms of the national real estate markets, Germany, for example, already has many years of experience with the above mentioned analysis of maximum loss rates (“Hard Test”). Across Europe, the competent supervisory authorities are currently carrying out a systematic review of the property markets in accordance with regulatory guidelines which will result in a prompter reaction to a rise in risk levels. We think this could be helpful for all parties. It would also be possible, for example, to analyse the historic loss rates or use the past due intervals prior to default at individual credit institute level to verify on an individual or portfolio level that no cash flow dependence exists for real estate financing.

If the Basel Committee is unable to follow up the above mentioned suggestion, we are of the opinion that individual verification can be provided: (i) if a commercial property is operated by the borrower himself (e.g. operator of a shopping centre or a hotel), it should be assumed that upon proof of third party usability, the property is non-cash flow dependent, (ii) if a commercial property is let by the borrower (but not operated), the property is non-cash flow dependent if there is a sustainable debt service coverage ratio (DSCR). At least, there is no cash flow dependence if the term of the loan does not exceed the term of the lease contract.

4. Residential Real Estate

Paragraph 56 shows the risk weight for cash flow dependent residential real estate financing. Footnote 50 explains that loans to co-operatively organised residential construction companies are excluded from the definition of a cash flow dependent real estate loan. The exception should be extended to include public sector residential construction companies, as these are never fully dependent on the cash flow generated by the financed property, but on the overall cash flow generated by a diversified property portfolio and are therefore not directly cash flow dependent. Public sector residential construction companies are responsible for the provision of rented apartments. A rise of the risk weight from its current level of 35% to a suggested level of at least 70% counteracts

the socio-economically meaningful activity of these companies and brings the minimum state provision of social housing into question.

We would recommend that the exception noted in footnote 50 is extended to include public sector residential construction companies.

5. Specialised lending

The revised standardised approach to credit risk will introduce a new distinction between specialised lending and real estate exposures. Given the additional function of the standardised approach as a floor for capital requirements calculated under the internal ratings-based approach (IRBA) we assume to use the same definitions throughout the IRBA as well.

6. FX Mismatch

According to paragraph 62 of the consultative document, in the case of, inter alia, real estate financing, in which the borrower's main source of income is not in the same currency as the loan, the risk weight of the loan is to be increased by an add-on of 50%.

We are of the opinion that this is not appropriate in terms of commercial real estate financing. These borrowers, mostly companies, operate under economic aspects and are therefore able to assess the advantages and disadvantages of a foreign currency loan. In this case, it can be assumed that these borrowers are able to undertake the risk management of their foreign exchange exposures. Commercial real estate financing should therefore be excluded from the scope of application.

7. Defaulted exposures (paragraph 75 et seq.)

Defaulted exposures should continue to be risk-weighted net of specific provisions as before. We especially welcome this. However, we cannot understand why a risk weight of 100% for non-cash flow dependent residential real estate financing and a risk weight of 150% are being suggested for all other real estate financing.

In the case of defaulted loans, there is on the one hand, no conceivable uncertainty remaining in terms of the risk of default. On the other, a value must be determined as part of the calculation of the specific provisions, irrespective of the type of property and conditions of the amortisation. The different treatment implies that the calculation of the risk weights in the case of loans secured by residential properties which are not cash flow dependent is 'more precise' than that for all other loans secured by residential or commercial properties.

In our opinion, there should be no differentiation between defaulted residential real estate loans and defaulted commercial real estate loans. Both types should be risk weighted at 100%, taking into account the specific provisions.