CRÉDIT FONCIER

Paris, le 27/03/2015

Consultative document - Revisions to the Standardised Approach for credit risk

CREDIT FONCIER RESPONSE

Crédit Foncier (CFF) is a French mortgage and public sector lender, and a subsidiary of Groupe BPCE. CFF welcomes the opportunity to respond to the Basel Committee's consultation on revisions to the Standardised Approach for credit risk.

General Comments

The Committee states in its introduction that "increasing overall capital requirements under the standardized approach for credit risk is not an objective". Yet for a number of banks under the standardized approach, including the specialized mortgage bank model which is widespread in Europe, the Committee proposals would lead to a significant upward change in required capital levels (see examples provided in answer to Q11).

There are already important differences in required levels of capital between Standard and IRB banks, and the proposal would only go to increase those differences (subject to the definition of the floor).

Regarding retail mortgage loans, and if one sets aside subprime lending in the US and specific pockets in Europe such as part of the Irish market or UK subprime, we cannot think of any meaningful jurisdiction where the financial crisis would have exposed the existing calibration as not being prudent (page 15 of the consultation). Even in countries such as Spain that did suffer an extensive real estate crisis, retail mortgage loans haven't generated high levels of losses. It therefore appears extreme to amend an international calibration in order to solve a localized issue.

While we understand why the Committee would want to focus on guarantees, we believe that some of the operational requirements (article 128 (a) in particular) are too detailed and should be left to the local regulator to appreciate. Taking the example of French public sector guarantees, which are very prevalent in the social housing and associative sectors for instance, the requirement for the bank to “have the right to receive payments from the guarantor without first having to take legal action” would mean none of them can be recognized, which would be in blatant contradiction with the protection they have been shown to provide in case of financial difficulties. Not all guarantees will be first demand guarantees and the fact that they are first demand or not is not the best way to approach their usefulness (e.g. sharp decline in the monoline guarantees business since the financial crisis).

The consultation does not address the case of covered bonds. We assume therefore that this debt instrument, which is of a highly senior nature, is not impacted by the proposed changes included in this consultation.

Exposures to banks

Q1: What are respondents’ views on the selection of the capital adequacy ratio? In particular, is the CET1 ratio superior to the Tier 1 ratio or the Leverage ratio? Do respondents agree that it is necessary to require calculations in accordance with Basel III in order to get a consistent implementation?

No answer provided

Q2: Do respondents believe the net NPA ratio is an effective measure for distinguishing a bank exposure’s credit risk? What alternative asset quality measure, if any, should be considered by the committee?

As it stands, the net NPA ratio does not give credit to guarantees received, which may well reduce the apparent level of provisioning. We believe for that reason that this ratio should be computed post LGD reduction measures used by the bank.

Q3: Do respondents have views on the proposed treatment for short-term interbank claims?

No answer provided

Q4: Do respondents have suggestions on how to address these concerns on the treatment of exposures to banks? In particular, do respondents have views on how to treat exposures to banks not subject to Basel III in a consistent and risk-sensitive manner?

No answer provided

Exposures to corporates

Q5: Do respondents have views on the selection of risk drivers and their definition, in particular as regards leverage and the incorporation of off-balance sheet exposures within the ratio? Would other risk drivers better reflect the credit risk of corporate exposures?

No answer provided

Q6: Do respondents have views on the appropriateness of the proposed treatment, especially with regard to SMEs? And about the more lenient treatment for start-up companies?

No answer provided

Q7: Do respondents think that the sensitivity of the proposal can be further increased without introducing excessive complexity?

No answer provided

Q8: Do respondents agree that introducing the specialized lending category enhances the risk sensitivity of the standardized approach and its alignment with IRB?

We believe that the proposed specialized lending category mixes together exposures pertaining to very different categories of risk. For example, an oil exploration project in an emerging market would be treated the same as a fully rented prime office property in London CBD. We believe that income producing real estate provides for much more predictable cash flows than most project or object finance transactions and as such is disadvantaged in the proposed grouping.

Also, while structuring real estate transactions, banks often require that the property being financed is isolated within an SPV so that the cash flows available to repay the loans are more predictable. Segregation allows the lender to take security over a valuable asset and its related cash flows, and to ring fence the structure from other creditors. For those reasons, the lender's position is significantly improved as compared to an unsecured corporate loan situation, and as a result we disagree strongly with the proposal that a higher risk weight would be warranted.

As to construction finance, the proposed risk weight of 150% is putting at risk the ability of the entire industry to access funding. Needless to say, that industry is significant in terms of *employment and impact on growth. The construction and commercial risks inherent to those loans may be more or less mitigated depending on the legal environment prevailing in a particular jurisdiction; in the case of France, the completion guarantee which a developer is required by law to obtain from a financial institution for the benefit of the buyer is quite effective at reducing those risks and as a consequence a condition precedent to bank loans typically includes high levels of precontracted tenants or buyers(i.e. 40% to 50% precontracted buyers for a multifamily property construction loan), thus reducing uncertainty of cash flows. A suggestion would thus be to allow national discretion in the case of required completion guarantees.*

Retail Portfolio

Q9: Can respondents suggest, and provide evidence on, how to increase the risk sensitivity of the regulatory retail exposures treatment, either by differentiating certain product subcategories for which a specific risk weight may be appropriate; or by suggesting simple risk drivers that could be used to assess the risk of all retail exposures?

No answer provided.

Exposures secured by real estate

Q10: Do respondents agree that LTV and/or DSC ratios (as defined in Annex 1 paragraphs 40 and 41) have sufficient predictive power of loan default and/or loss incurred for exposures secured on real estate?

CFF believes that the LTV ratio is indeed predictive of loan default and/or loss incurred for exposures secured by real estate.

However, this predictive power is more questionable for the DSC ratio. First, it would be nearly impossible to implement a homogeneous DSC ratio across countries. In addition, higher revenues may well afford higher DSC without increasing clients' propensity to default

Q11: Do respondents have views about the measurement of the LTV and DSC ratios , (in particular, as regards keeping the value of the property constant as measured at origination in the calculation of the LTV ratio; and not updating the DSC ratio over time.)

We see two issues with the proposed DSC calculation:

- *(i)* *The proposed calculation is "net of tax". Depending on the jurisdiction, and whether it uses or not payment of income tax at source, the ratio may or may not be computable. Also, depending on jurisdiction, the array of taxes may go well beyond income tax, which would unduly complicate the calculation (e.g. property tax), and the reason why it is not market practice in a country such as France.*

(ii) *For buy to let loans, one might certainly want to guard against excessive expected rent from the property being financed, but removing any recognition of that rental income as a matter of course is hard to justify and would severely affect the ability of retail investors to take part in the private rental market, with associated macro-economic consequences.*

Regarding the LTV,

(i) *The requirement for banks not to tranche their exposures across different LTV buckets would have several negative consequences:*

a. *Cliff effects would be created around the LTV thresholds as shown in the examples below.*

LTV	**79%**	**80%**	**89%**	**90%**	**99%**	**100%**
Existing RW	35%	35%	39%	39%	43%	43%
Proposed RW*	40%	50%	50%	60%	60%	80%

*assuming DSC<35%

b. *Sharp increase of risk weights for LTVs above 80% where most of the market and certainly the market for first time buyers lies, which appears to contradict the stated objective of the Committee of not increasing overall capital levels*

c. *Regulatory arbitrage opportunities would be opened: banks could extend several loans with different lien rankings based on the bucket thresholds, or a property purchase could be funded by several banks, on the basis of those same thresholds.*

			DSC ≤ 35%							
			LTV = 30%	LTV = 40%	LTV = 50%	LTV = 60%	LTV = 70%	LTV = 80%	LTV = 90%	LTV = 100%
RW	One loan		**25%**	**30%**	**30%**	**40%**	**40%**	**50%**	**60%**	**80%**
	Combination of loans	0/40	25%	25%	25%	25%	25%	25%	25%	25%
		40/60		30%	30%	30%	30%	30%	30%	30%
		60/80				40%	40%	40%	40%	40%
		80/90						50%	50%	50%
		90/100								60%
		overall	**25%**	**27%**	**27%**	**30%**	**30%**	**32%**	**32%**	**35%**
RW gain when several loans vs. one loan			**0%**	**3%**	**3%**	**10%**	**10%**	**18%**	**28%**	**45%**

We therefore strongly believe that the same tranching approach as the one used today should prevail.

(ii) *The consultation assumes that a valuation will always be available. In the majority of cases, the transaction price between buyer and seller is the best valuation one may hope for, which is why requiring a valuation for each and every retail mortgage loan is not market practice in France.*

(iii) *We do not understand the requirement for the property to be fully completed, given the protective environment available under VEFA or VIR in France, whereby a bank completion guarantee for the benefit of the acquirer/borrower is required from the outset (same comment as Q8).*

Q12: Do respondents have views on whether the use of a fixed threshold for the DSC ratio is an appropriate way for differentiating risks and ensuring comparability across jurisdictions? If not, what reasonably simple alternatives or modifications would respondents propose while maintaining consistent outcomes?

See answer to Q10.

Q13: Do respondents propose any alternative/additional risk drivers for the Committee's consideration in order to improve the risk sensitivity in this approach without unduly increasing complexity?

At the very least, we believe there is a strong inconsistency of calibration in the proposed framework: if unsecured regulatory retail exposures are risk weighted at 75%, it would be inconsistent for exposures secured on property to reach levels above that, such as the 80% or 100% being proposed, depending on LTV and DSC.

Exposures secured by commercial real estate

Q14: Which of the two options above is viewed as the most suitable for determining the risk-weight treatment for exposures secured on commercial real estate?

Option A does not reflect the much superior position of a lender secured with a first mortgage versus an unsecured lender, except in cases covered by the national discretion. Option B is sounder in principle but would represent a sharp increase from current levels and as such should include the national discretion that is being suggested in option A. We also have similar comments as in Q11 regarding the proposed absence of tranching with which we disagree (leads to cliff effects and to regulatory arbitrage opportunities) and reservations about the differentiation between completed properties or not in cases where a completion guarantee is in place.

Q15: what other options might prudently increase the risk sensitivity of the commercial real estate treatment without unduly increasing complexity?

No answer provided.

Risk weight add-on for exposures with currency mismatch

Q16: Do respondents agree that a risk weight add-on should be applied to only retail exposures and exposures secured by residential real estate? What are other options for addressing this risk in a simple manner?

No answer provided.

Off-balance sheet exposures

Q17: Do respondents consider the categories for which a CCF is applied under the standardized approach to be adequately defined?

No answer provided.

Q18: Do respondents agree that instruments allocated to each of the CCF categories share a similar probability of being drawn and that the probabilities implied by the CCFs are accurate? Please provide empirical support for your response.

No answer provided.

Past Due Loans

Q19: What are respondents' views on the alternative treatments currently envisaged for past-due loans?

We believe the add-on approach to be the most effective one

Exposures to multilateral development banks

Q20: Do respondents agree with the proposed treatment for MDBs?

No answer provided.

Other assets

Q21: What exposures would be classified under "Other assets"? Is a 100% risk weight appropriate?

No answer provided.

Eligible financial collateral

Q22: What are respondents' views on the above alternative ways to define eligible financial collateral?

No answer provided.

Q23: What are respondents' views on the recalibrated supervisory haircuts shown in Table 4? What are respondents' views on how to eliminate references to ratings from the supervisory haircuts table? What could be the implications of eliminating references to external ratings?

No answer provided.

Eligible credit protection providers

Q24: What are respondents' views on the proposed corporate guarantor eligibility criteria?

No answer provided.