

Paris, le 10/03/2016

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.

Executive summary

CFF acknowledges that the Basel Committee significantly amended its first consultation paper. As a consequence, the second revision essentially addresses the real estate exposure class. Besides, the suggested prudential treatment of these exposures significantly increases capital requirements not only in comparison with current prudential treatment but also vs. the first consultative document. Consequently, our below detailed comments focus on real estate exposures. Our main focuses are listed here below and detailed further down:

- (i) **There should be consistency between risk weight across different exposure classes, so that secured exposures are not penalized compared with unsecured exposures.**
- (ii) **The requirement for banks not to tranche their exposures across different LTV buckets** has several negative consequences:
 - a. It creates cliff effects around LTV thresholds.
 - b. It significantly increases risk weights for exposures the LTV of which are above 80% i.e. for most of the market and certainly for first time buyers.
 - c. It encourages regulatory arbitrages among banks. Exposures could be split so that each bank minimizes its LTV and optimizes RWA.
- (iii) **There is a significant increase in risk weights for the “buy-to-let” portfolio that was formerly called Income Producing Real Estate (IPRE)** while, in many countries, it is not riskier than the rest of the residential portfolio (cf. ACPR analysis entitled “Housing finance in France in 2014” published in July 2015).
- (iv) While we understand why the Committee wants to focus on guarantees, **we believe that some of the operational requirements (article 170 (a) in particular) are to be fine-tuned and should be left to the local regulator to appreciate.**
- (v) **The suggested risk weights for exposures financing under construction properties are excessive.** Besides, in France, we have a legal mechanism (called Garantie Financière d’Achèvement - GFA), which is compulsory and ensures any buyer/borrower that the property will be completed in case the developer defaults. Furthermore, most of the built properties are purchased under a secured mechanism called VEFA.
- (vi) The increases in risk weights will negatively impact not only newly granted but also formerly approved exposures. However, should a bank want to increase its margins to improve its profitability and therefore its capital reserves, the benefits of this increase will only be observed on the new production of loans. Consequently, **we strongly support the introduction of a grand-fathering clause.**

General comments on the real estate exposure class

- **Unsecured retail exposures benefit from a lower risk weight than real estate exposures that are secured and with high LTV ratios**

On the one hand, according to article 46 of the consultative paper, “retail exposures that meet all of the criteria [...] will be risk-weighted at 75%, unless the exposure is defaulted according to paragraph [75].”

The above mentioned list of criteria does not include any requirement on a collateral nor a guaranty.

On the other hand, all the articles relative to real estate secured exposures (from 53 to 61) suggest higher risk weights than the 75% above mentioned notably with high LTV ratios.

This inconsistency could encourage regulatory arbitrage where:

- Residential mortgages could be requalified as unsecured retail exposures.
- Commercial real estate exposures could be requalified as exposures to corporates.

- **The LTV ratio**

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

However, the CFF underlines two items that requires additional amendments to the suggested text:

(i) The definition of finished property, in article 50:

This article states that “subject to national discretion, supervisors may apply the risk-weight treatment described in paragraph [54] for loans to individuals that are secured by residential property under construction” should one out of two conditions is met. These conditions raise the following issues:

- a. The one to four units condition is tied to the definition of multifamily in the US (or rather what is not a multifamily), and bears no relevance in large parts of the world. Phrased as such, this requirement will maintain the status quo in the US, where most people live in individual houses, whilst penalizing other jurisdictions, including in the EU, where apartments are the norm. BCBS should take into account the diversity of the Real Estate markets in the wording of this condition.
- b. The second condition wording should be improved. As a matter of fact, in France, a legal mechanism called Garantie Financière d’Achèvement (GFA), which is compulsory for any residential building under construction, ensures any buyer/borrower that the property will be completed in case the developer

defaults. The guarantee is provided by an insurance company or financial institution, not the sovereign or a PSE. Yet, this mechanism clearly fulfills the spirit of the second condition, even though the enforcer is neither a sovereign nor a PSE. One could argue that the sovereign in this case has used its legal powers to pass the law instituting GFAs and as such meets the condition, but this interpretation is not crystal clear.

(ii) The definition of the LTV ratio, in article 52:

The value in the LTV ratio is not updated over the life of the loan, whereas the CRR requires the value of the collateral to be updated.

Besides, 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.

The fixed value of the property in the LTV ratio could encourage refinancings at regular intervals in order to update the value every time a new loan is granted.

- **Loan tranching**

Footnote 44 p. 35 states that “if a bank grants different loans secured by the same property and they are sequential in ranking order (ie there is no intermediate lien from another bank), the different loans should be considered as a single exposure for risk-weighting purposes, and the amount of the loans should be added to calculate the LTV ratio.

The requirement that the risk weight be assigned to the total exposure amount would have the following effects:

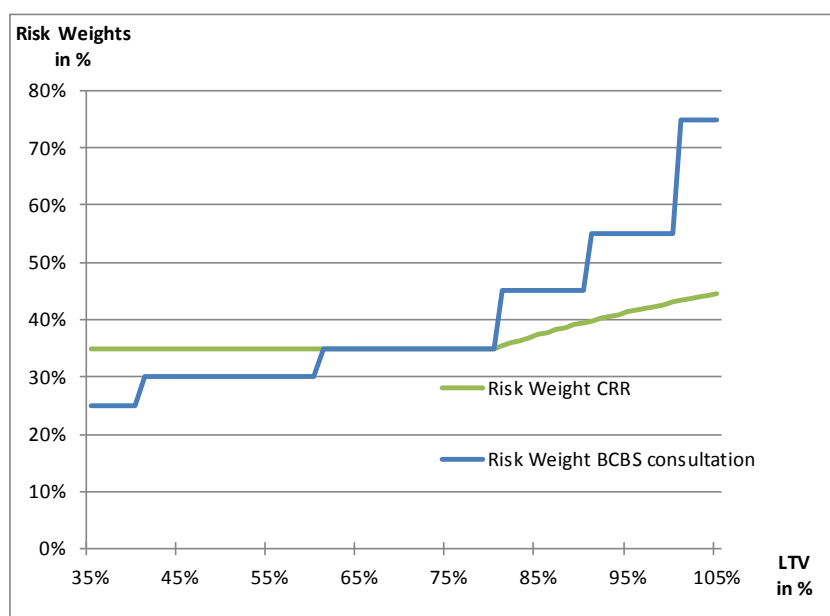
- (i) A significant **increase in the capital charge** for residential real estate. This is especially damaging for first time buyers which naturally fall into the high LTV tail for residential real estate. For example, in several EU jurisdictions first-time buyers can have an LTV well above 80%. In the revised BCBS proposal, the risk weight for such an exposure would be 75%, dramatically up from the 43% in the current Standardised Approach.
- (ii) **Perverse incentives:** The lack of loan tranching would result in regulatory arbitrage; 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 the same thresholds. In other words, the present proposal creates an incentive to split a loan into several loans for example from 0-40 % LTV, from 40-60 % LTV and so on. From a lender's perspective, this would reduce the risk

adjusted exposures but from a consumer's perspective this will create more expense with the registration of for example three loans instead of one loan.

			LTV = 30%	LTV = 40%	LTV = 50%	LTV = 60%	LTV = 70%	LTV = 80%	LTV = 90%	LTV = 100%	LTV = 110%
RW	One loan		25%	25%	30%	30%	35%	35%	45%	55%	75%
	Combination of loans	0/40	25%	25%	25%	25%	25%	25%	25%	25%	25%
		40/60			30%	30%	30%	30%	30%	30%	30%
		60/80					35%	35%	35%	35%	35%
		80/90						45%	45%	45%	45%
		90/100							55%	55%	55%
		100/110								75%	75%
Overall		25%	25%	26%	27%	28%	29%	31%	33%	37%	
RW gain when several loans vs. one loan			0%	0%	4%	3%	7%	6%	14%	22%	38%

- (iii) **Introduction of significant cliff effects:** Particularly given the steepness of the increases in risk weights on the high LTV end, retention of loan tranching – even if accompanied by some recalibration of the actual RWs – is desirable. Otherwise, a small incremental increase in LTV would result in a significant increase in the RW of the whole exposure.

Please find below a diagram that illustrates the cliff effects of Risk Weights depending on LTV, for residential real estate exposures, when the property is completed and repayment does not materially depend on cash flows:



Loan tranching is a sensible solution to the high capital charge deriving from residential real estate. CFF believes that a risk sensitive approach requires that the exposure can be split receiving two different, but appropriate, risk weights. Loan-tranching has the following advantages:

- It currently works well and avoids sharp discontinuities when a loan moves into the next LTV band i.e. it gives a smoother correlation between LTV and effective risk weights.
- It makes the framework more risk sensitive without unduly increasing the complexity of the methodology.

- **The eligibility criteria for guarantees**

While we understand why the Committee would want to focus on guarantees, we believe that some of the operational requirements (article 170 (a) in particular) are too detailed and should be left to the local regulator to appreciate.

With regard to sovereign guarantees, i.e. paragraph 181 of the CP, a lower risk weight should be applicable, even if the guarantee does not meet the operational requirement 170 (a), which requires that the guarantor must pay before the beneficiary first takes legal action. What matters is that the guaranty is unconditional, i.e. is not subject to conditions precedent. Whether it is paid upfront or later is less relevant. The requirement of not having to take legal action against the counterparty should be replaced by a requirement of the guaranty being unconditional.

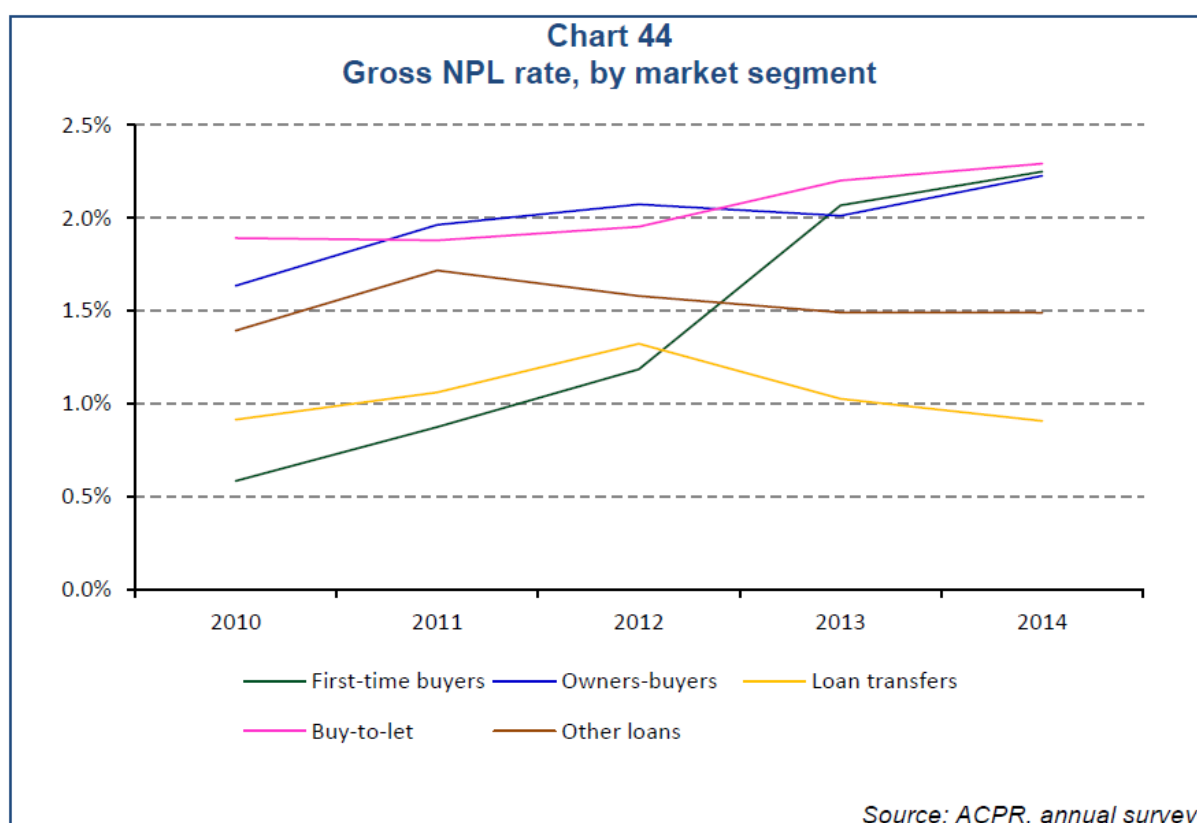
- **The need for a grand-fathering clause**

The increases in risk weights will negatively impact not only newly granted but also formerly approved exposures. However, should a bank want to increase its margins to improve its profitability and therefore its capital reserves, the benefits of this increase will only be observed at maturity of the new production of loans. Consequently, we strongly support the introduction of a grand-fathering clause.

Residential real estate exposures

In the “Next steps” paragraph, page 3 of the second consultative document, the Basel Committee mentions that “Increasing overall capital requirements under the SA for credit risk is not an objective of the Committee; rather, capital requirements should be commensurate with the underlying risk”. However, articles 54, 55 and 56 of the second consultative document significantly negatively impact first time buyers, buy-to-let and properties that are under construction.

- (i) First time buyers (where LTV can be close to 100%) are heavily penalized: for a 100% LTV, risk weight is 75% as per the second consultation vs. 43% in the CRR.
- (ii) Buy-to-let is also unfairly penalized (article 56) while, in France (cf. ACPR analysis entitled “Housing finance in France in 2014” published in July 2015), comparable levels of losses are observed as compared with the real estate exposures that do not depend on cash flows.



Besides, the 150% risk weight and the 120% risk weight corresponding to LTV above 80% (as per grid of article 56) should the repayment capacity depend on the cash flows generated by the property securing the loan are higher than the 100% risk weight for defaulted real estate exposures (as per article 78) and other

assets (cf. article 80). This is inconsistent with the Basel Committee statement that is quoted above.

(iii) Properties under construction are addressed above.

Consequently, we would like to propose the following alternative risk weightings, based on the same tranching as the one currently used in the CRR i.e. each risk weight is the marginal risk weight of the tranche:

	LTV ≤ 40%	40% < LTV ≤ 60%	60% < LTV ≤ 80%	80% < LTV ≤ 90%	90% < LTV ≤ 100%	LTV > 100%
Marginal RW by tranche	15%	30%	80%	90%	100%	100%
This translates into the following risk weights for loans at the following LTV levels:						
Loan LTV	40%	60%	80%	90%	100%	
Loan RW	15%	20%	35%	41%	47%	

The CFF also believes that the risk sensitivity of the approach should be further enhanced by reducing risk weights further for low LTV exposures, and also introducing additional buckets for exposures with LTVs lower than 40%. The security against low LTV exposures, particularly in view of the valuation stability which results from the use of origination value to determine LTV, will provide significant credit risk mitigation which should be reflected in risk weighting. Such an approach would provide an appropriate incentive to banks to improve levels of security made against such lending, but also narrow the potential divergence between risk weighting for low LTV exposures under risk sensitive IRB modelled approaches and the standardised approach

Commercial real estate exposures

Similar to buy-to-let, commercial real estate is unfairly penalized (articles 58 and 60). When LTV is higher than 60%, the corresponding risk weight (regardless the dependency on cash flows generated by the property) is at least 100% which corresponds to the risk weight for defaulted real estate exposures (as per article 78) and other assets (cf. article 80). Therefore, the second consultative document creates a situation where a secured exposure receives a higher risk weight than an unsecured exposure.

Besides, this is inconsistent with the Basel Committee statement relative to containing capital consumption.

Land acquisition, development and construction exposures

The ADC loan risk weight treatment relies on the fact that the “source of repayment at origination of the exposure is either the future uncertain sale of the property or cash flows whose source of repayment is substantially uncertain”.

After the demonstration that the future sale of property or future cash-flows to allow repayment of the loan is NOT substantially uncertain, we propose the Committee to give a 100 % Risk Weight to the eligible development loans.

Such demonstration will be based on minimum thresholds (signed sales or pre-sales/pre-leases) to reach depending on the asset type.

- **Residential development financings**

The residential development financing scheme, which is a common market practice shared by all French banks, relies on two key protective elements (both legal and financial):

- o The immediate transfer of the legal ownership from the developer to the purchaser(s) through signed notarial acts, even though the building is not completed, and the presence of a bank completion guarantee. Such practice protects all parties (developers, bankers and final buyers). It is, in particular, common in France (strongly sponsored by the national competent authority – ACPR – and legally compulsory for the completion guaranty) through the legal mechanism of VEFA (Vente en Etat Futur d'Achèvement, defined since 1967 by French law) and GFA (Garantie Financière d'Achèvement). We understand that similar legal schemes exist for instance in Luxembourg.
- o The presence of signed notarised sales as condition precedent. Such signed notarised sales are one of the key elements to secure the transaction (together with the equity and the developer's margin), to validate the "adequacy" of the asset within its market and to demonstrate the likelihood of the future sales coming from the residual stock and their future related cash flows.

These legal/financial protections have demonstrated their efficiency during the past years, with very low historical default rates observed in such activity.

As long as signed notarised sales represent a minimum of 30% of the expected total sale revenues of the residential development programme, we propose to give a 100 % risk weight to these loans.

- **Nonresidential development financings**

Banks are also strong partners for the development financings of commercial projects (offices, retail, logistics and hotels).

These financings are often secured by signed notarised sales to investors under the VEFA mechanism, which is a key element to secure the future cash-flows but they rely on a more volatile asset risk profile than residential development financings.

They can also be secured by pre-leases (BEFA: Baux en état futur d'achèvement) to secure as well the future cash-flows deriving from the asset(s) at completion

Therefore, to be consistent with the risk-sensitive approach among ADC loans (which depends both on the asset type – residential or not residential - and on the level of legal “strength” of the condition precedent – signed notarized sales or pre-leases), we propose the followings:

- **If the asset is sold (through VEFA) for an amount representing 100 % of the expected total sale revenues, we propose to give a 100 % risk weight to the loan.**
- **If the asset is pre-leased for an amount representing 70 % of the expected revenues deriving from the asset at completion (thus giving a high probability for the asset to be sold at completion), we also propose to give a 100 % risk weight to the loan.**
- **Finally, if the LTV at completion is less or equal to 80 % (which is consistent with the approach summarized in table 12 page 37) AND either signed notarized sales or pre-leases represent a substantial amount of the total expected revenues, we also propose to give a 100 % risk weight to the loan.**

Finally, it is worth to recall that the Real Estate asset class is the largest in the world. In particular, in France, it is a key economic sector strongly sponsored by the government with a will to build ca 500.000 housings and commercial real estate (offices, retail, logistics, hotels). Development loans in France represent a stock of ca €20 bn in 2015.

A penalizing treatment for loans fulfilling the above described conditions (legal and financial protections) could jeopardize the financing scheme of a whole strategic economic sector and could lead either to a credit crunch or a significant rise of pricings, unaffordable for borrowers.

Thus we propose the following formulation for § 61

“61. Land acquisition, development and construction (ADC) lending will be risk-weighted at 150%. ADC includes loans to companies or SPVs financing any of the land acquisition, development and construction of any residential or commercial properties where the

source of repayment at origination of the exposure is either the future uncertain sale of the property or cash flows whose source of repayment is substantially uncertain. ADC exposures will also include loans to companies or individuals to finance the acquisition of finished property where the repayment of the loan depends on the future uncertain sale of the property.

The repayment of the loan is deemed to be sufficiently secured by both the immediate certain sale of a significant proportion of the property to be developed or by the signature of pre-leases as condition precedent for the following cases:

Residential / Signed notarised sales	Non Residential / Signed Notarised Sales	Non Residential / Preleases	Non residential / other cases
30% of the expected total sales revenues	100% of the expected total sales revenues	70% of the expected leases revenues	LTV <= 80% and a substantial amount of sales or preleases have been signed

In such cases, the loan will be subject to a Risk weight of 100%.