CRIF COMMENTS ON BASEL COMMITEE ON BANKING SUPERVISION CONSULTATION PAPER "REVISIONS TO THE STANDARDISED APPROACH FOR CREDIT RISK"

26 March 2015

CRIF is a global company specializing in the development and management of credit reporting, business information and decision support systems. Established in 1988 in Bologna (Italy), CRIF has an international presence, operating over four continents (Europe, America, Africa and Asia). The company supports banks and financial institutions, insurance companies, utilities and general businesses in every phase of client relations. CRIF is currently the leading group in continental Europe in the field of banking credit information and one of the main operators on an international level concerning integrated services for business & commercial information and for credit & marketing management. More than 2,400 banks and financial institutions and 25,000 businesses worldwide use CRIF services.

CRIF welcomes the proposal of the Committee and agrees with the Objectives of the review stated in section 1.1.
It is of utmost importance to work for a greater comparability of measures and capital requirements, either among standardised and IRB approaches as well as among different jurisdictions.
CRIF is also convinced that mechanicistic reliance on external credit assessment needs to be addressed, and that there are conditions on which alternative risk measures could be taken into account.

Referring to exposures secured by residential real estate CRIF strongly believes that it would be preferable to correlate current LTV to risk weighting by periodically re-measuring loan balance and current market value of the property collateral (without keeping the value of the property fixed at the time of origination) and suggest that valuation could be performed by an independent and external appraiser.

Following CRIF comments to the specific Basel Committee proposals.

(2.2) EXPOSURES TO CORPORATES

Q6 and Q7. Provided that corporates include SMEs as well as individual firms and start-ups, CRIF wanders where the risk indicators proposed by the Committee are suitable for all corporates. There are regions in Europe where the entrepreneurial texture is quite totally composed by micro and individual companies that are not obliged to issue a balance-sheet[1]. For those corporates the point is not whether to consider off-balance sheet exposures or not, the question is how to determine the risk drivers necessary for the credit risk assessment in the lack of even balance-sheet figures. This applies to start-ups too, as balance-sheet information are more probably not available.
On the other hand, there is a need not to create excessive burdens on SMEs, start-up companies, and finally to risk managers of banks and investors.

[1] In Italy, on a rough total of 6 million corporates, only 900,000 issue a balance-sheet, resulting in 85% of corporates without native risk driver information.

That said, CRIF believes that regardless of the final risk drivers that the Committee will select, an effort shall be made in order to find alternative measures for SMEs and start-ups, or, alternatively, to individuate efficient proxies of the risk indicators starting from available and reliable sources.
As such, credit bureaus and commercial credit data bases could serve to provide measures of the corporate solvency and liquidity, and contribute to determine the total assets, as well as be used to estimate future performance on the basis of actual and past performances, and to provide comparative performance for those firms where punctual information are too new or poor even to determine alternative measures.
It is worth pointing out that credit bureaus and commercial credit data bases can easily provide such metrics and have the advantage to count on a monthly sample period - thus allowing to base the risk assessment on fresher information, and a prompter acknowledgement of a degradation of the risk indicators.
Finally it is also important to highlight that there are still national barriers that do not allow credit bureaus to collect and make available to banks and investors all data potentially useful for risk measure and assessment, and to retain them for a time period sufficient for all risk assessment analyses[2].
CRIF is fully available to support the Committee with more evidences across European geographies and to perform simulations whether this would help the Committee in the decision process.

(2.2) RETAIL PORTFOLIO

Q9. As stated in the Treatment paragraph (2.4.1 – ii) applicable risk drivers are:
(i) The extent to which a loan is secured by durable goods;
(ii) The percentage of the borrower income available to service the loan;
(iii) The maturity of the exposure;
(iv) Whether there is already an established relationship between the borrower and the bank.

Concerning the percentage of the borrower income available to service the loan, CRIF would like to observe the following.
Income: we suggest to extend this measure to savings and assets, more generally to wealth. Just to give a national example, the wealth of Italian households calculated by Bank of Italy at the end of 2013 is 8,728 EUR billions (rough 4 times the sovereign public debt) and corresponding to mean 144,000 EUR per subject and 356,000 EUR per household (60% on real activities and 40% on financial activities)[3]. Limiting the measure to income would probably penalize those geographies where saving and other assets are still strong and consistent. Moreover, income shall be verifiable from a reliable source in order to facilitate data retrieval and risk driver calculation.
The percentage: when calculating the percentage of income (plus wealth) available to service the loan, other existing financial commitments shall be taken into account, thus using information available from credit bureaus and credit reference agencies as correctly referred to in Section 2.5 (claims secured by real estate), para 41.
Finally the measure (ii) shall be periodically reviewed in order to take into account changes in commitments, in income and wealth, as well any other situation that could affect the capability of the borrower to fulfill his own obligations.

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[2] Evidences can be retrieved in the ACCIS membership surveys, periodically published in ACCIS website (www.accis.eu), on both retail and SMEs credit reporting.
[3] https://www.bancaditalia.it/pubblicazioni/ricchezza-famiglie-italiane/2014-ricchezza-famiglie/suppl_69_14.pdf

Going more specifically to Q9, one of the major objectives of credit reporting service providers is to help banks and investors to assess the risk of retail exposures, leveraging on the complete picture of retail credit and not on single portfolios. Thus CRIF strongly believes that credit reporting is one (and simple) risk driver that could be used to assess the risk of all retail exposures.

(2.5) EXPOSURES SECURED BY REAL ESTATE - RESIDENTIAL REAL ESTATE COLLATERAL

This paragraph contains CRIF comments to the following Basel Committee proposals, related to exposures secured by residential real estate.

BASEL COMMITTEE CONSULTATION PAPER PROPOSAL

37. *The property securing the mortgage must meet the following operational requirements:* ***Finished property****, Legal enforceability, Prudent value of property: the property must be valued according to the criteria set in paragraph [40] for determining the value in the LTV ratio.*

CRIF COMMENT

In Italy, new mortgages secured by residential unfinished property are possibly between 5-10% of new mortgages granted to individuals. Therefore it represents an important category, which shouldn't be considered and treated as an "other retail" exposure. We suggest to apply directly the risk-weight treatment described in paragraph [38] also to loans secured by an unfinished property represented by a residential housing unit which is for a one to four family, without being subject to any national discretion.

BASEL COMMITTEE CONSULTATION PAPER PROPOSAL

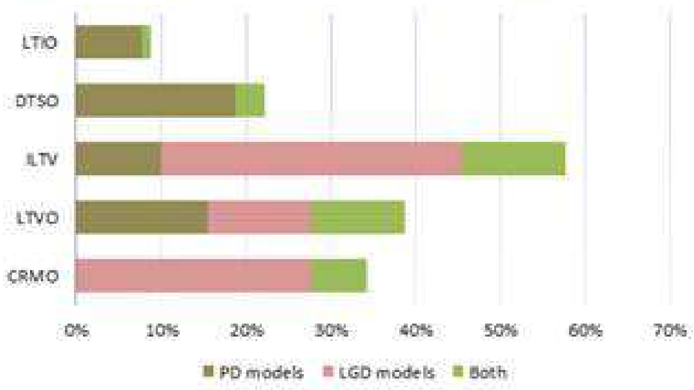
40. *For regulatory capital purposes, when calculating the LTV ratio,* ***the value of the property will be kept constant at the value measured at origination****,* ***unless an extraordinary, idiosyncratic event occurs resulting in a permanent reduction of the property value****. Modifications made to the property that unequivocally increase its value could also be considered in the LTV.*

CRIF COMMENT

Considering the current economic scenario, keeping the value of the property constant at the value measured at origination (unless an extraordinary, idiosyncratic event occurs resulting in a permanent reduction of the property value) seems not so prudent.

Concerning the use of LTV at origination, we strongly believe that it would be preferable to correlate Current LTV to risk weighting by periodically re-measuring loan balance and current market value of the property collateral. In fact, the European Banking Authority points out that "*examining the correlation and variability analyses, the indexed loan-to-value (ILTV) is the variable which most significantly influences RW variation*" (see image below).

Figure 3: Percentage[15] use of the variables in the PD/LGD/both estimations



Source: EBA data collection (reference date: December 2012); EBA calculation

We are firmly convinced that market value should be routinely monitored on a loan-by-loan basis, especially now that we have seen that the property market is not one of constant growth. In Italy, for example, property prices have decreased on average by 15% in the last three years, significantly changing Current LTV:

Source: ISTAT, Residential Real Estate Prices, January 2015

If we consider an average loan originated in 2011 of 150.000€ backed by real estate collateral worth 190.000€ the LTV at origination would be 78% and on the basis of the current Consultative Paper, the loan would fall in the RWA bucket of 40%. However, if we assume that an average loan of 20 years with a French amortization plan, in 2014 the loan balance would be about 133.000€, while the property market value in the current cycle depicted above, could potentially have fallen to 162.000€. Therefore the real adjusted Current LTV would be 82%, therefore the loan should be correctly reclassified in the 50% RWA bucket. If current property market value is not monitored regularly on a loan-by-loan basis, this risk would not be identified.

BASEL COMMITTEE CONSULTATION PAPER PROPOSAL

40. *The valuation must be appraised independently.* **Note 55:** *The valuation must be done independently from the bank's credit underwriting process;* ***it does not need to be carried out by third-party appraisers.***

CRIF COMMENT

In order for a valuation process to be able to support effectively the valuer's independence, it has to include: valuers selection and training; centralized management of job assignments (guaranteeing rotation), monitoring, quality control on each valuation report. Even if this process could be implemented also by an internal team, an external valuation company can best assure to implement such a process in a truly independent way and to protect the individual valuer performing the inspection from any undue influence. For this reason, nowadays most Italian banks and mortgage insurance companies require valuations on mortgage collaterals to be performed exclusively by external valuation companies, while in the past individual valuers or internal valuers were often employed.

A similar position has been adopted by the ECB in the AQR Phase 2 Manual, considering acceptable only valuation performed by an independent, external appraiser.

Also the US Federal Register, in its Interagency Appraisal and Evaluation Guidelines states that *"appraisers must be independent of the loan production and collection processes and have no direct, indirect or prospective interest, financial or otherwise, in the property or transaction. These standards of independence also should apply to persons who perform evaluations. For a small or rural institution or branch, it may not always be possible or practical to separate the collateral valuation program from the loan production process.* ***If absolute lines of independence cannot be achieved, an institution should be able to demonstrate clearly that it has prudent safeguards to isolate its collateral valuation program from influence or interference from the loan production process****. In such cases, another loan officer, other officer, or director of the institution may be the only person qualified to analyze the real estate collateral. To ensure their independence, such lending officials, officers, or directors must abstain from any vote or approval involving loans on which they ordered, performed, or reviewed the appraisal or evaluation."* (Federal Register/ Vol 75 / N.237 / Friday, December 10, 2010 /Notices p.77457).

BASEL COMMITTEE CONSULTATION PAPER PROPOSAL

40. Note 56: *To ensure that the value of the property is appraised in a prudently conservative manner, expectations of future price appreciation should not be considered. In addition,* ***when the current property price is above a level that is sustainable over the life of the loan (eg due to a property price bubble), the valuation should be adjusted. National authorities should provide guidance setting out prudent valuation criteria****. If a market value can be determined, the valuation should not be higher than the market value.*

CRIF COMMENT

This statement is confusing in terms of prices and values.

The **value** of an asset is an estimated amount rather than a predetermined amount or actual sale price. It is the **price** in a transaction that meets all the elements of the market value definition at the valuation date.

Moreover, referring to values, we have to distinguish two different kind of values:

- **Market Value -** "*The estimated amount for which the asset should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion*." (EVS 2012 – EVS1). Market Value is a key concept in establishing an informed expectation as to the price for something, one that is neutral as between buyer and seller. The "market value" of an asset is understood to mean its "current value in the market, saleable value" (*Oxford English Dictionary*) irrespective of actual parties

- **Mortgage Lending Value -** *"The value of the property as determined by a prudent assessment of the future marketability of the property taking into account long-term sustainable aspects of the property, the normal and local market conditions, the current use and alternative appropriate uses of the property. Speculative elements shall not be taken into account in the assessment of the Mortgage Lending Value."* (EVS 2012 – EVS2) The concept of Mortgage Lending Value (MLV) is of particular value in the context of long term lending programs. It is a value-at-risk approach taking into account special safety requirements. In contrast, the concept of Market Value is universally understood as representing a market assessment of value at a given point in time.

This Basel proposal seems to suggest the use of Mortgage Lending Value (MLV) instead of Market Value, in order to estimate the value of a property. But using MLV, LTV ratio would amount to a maximum of 30%-40%, that could freeze and strongly penalize the development of European mortgage and real estate markets.

Furthermore, in Italy, as well as many other European countries, there is no established practice for MLV estimation, not even historical data that could provide a predictive database to determine sustainable values over time, depending on asset's characteristics. Overall, we suggest fixing value in LTV calculations at Market Value (as defined by TEGoVA EVS 2012) and monitoring it regularly over time.

Thank You for Your Attention
Kind Regards

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