

Date 10 March 2016

Reference NVB response to the second Basel SA Revision consultation

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel, Switzerland

Dear Sir/Madam,

We welcome the opportunity to provide feedback on the second consultative document “Revision to the Standardised Approach for credit risk”. Several Dutch banks contributed to the response letters of EBF, EMF, IIF, IBfed and EAPB¹; therefore to a large extent we underpin their responses. Next to these responses we also would like to emphasize the Dutch context through this response letter.

Overall we are of the view that the second consultative document is an improvement compared to the first.

- We are glad that the use of external ratings is allowed in certain jurisdictions. Allowing external ratings reduces the complexity and increases the risk sensitivity.
- Also the removal of the Debt Service Coverage Ratio (DSCR) as one of the two risk drivers for residential mortgages we consider an improvement. Even though we are of the strong view that the ability to pay is a crucial risk driver, it seems impossible to calibrate it in a one-size-fits all global framework.
- Finally the classification (taxonomy) of the real estate assets we consider an improvement, which increases the transparency of the classification of these assets.

However, we have serious concerns about certain parts of the consultative document, which we highlighted in this response paper together with suggestions for improvements for the revision of the Standardised Approach (SA) for credit risk. In Annex I we provided additional background information on our residential real estate concerns. In short, our main concerns are:

- The flat risk weights for specialised lending exposures are extreme conservative and do not take into account the risk mitigating structures. We suggest a significant re-calibration of the risk weights, we suggest to allow non-financial collateral as eligible form of credit risk mitigation and suggest allowing the slotting method under the SA framework, or a simplified alternative thereof.
- The Credit Conversion Factors (CCFs) for unconditionally cancellable commitments (UCCs) for non-retail significantly overestimate the risks. Therefore, a significant reduction of these CCFs is required. An unambiguous set of definitions for CCFs that correctly isolate the UCCs from the other off-balance sheet commitments is crucial.

¹ EBF = European Banking Federation; EMF = European Mortgage Federation; IIF = Institute of International Finance; IBfed = International Banking Federation; EAPB = European Association of Public Banks

- For residential real estate loans the proposed calibration of the risk weights does not reflect the risk profiles of low risk mortgages portfolios, including the Dutch. We suggest to allow local calibration, or to set lower risk weights as a base case, which fits well in the BCBS strategy to set global minimum standards. Jurisdictions with riskier portfolios could set higher risk weights accordingly.
- Also related to real estate exposures, in line with the current practices within the Internal Rating Based (IRB) and SA frameworks, in our view it is very important to allow updating the property values (house prices) periodically. It would ensure a stronger link between actual risks and capital requirements.
- Finally, although not part of the SA consultation, we suggest that the BCBS reconsiders their plan to introduce a capital floor based on SA. It seems the BCBS will introduce input floors on IRB (on PD and LGD values), also there is already a non-risk sensitive leverage ratio. There is no reason to have an output floor on top of all this.

Correctly ranking all assets from low risk to high risk

- The BCBS indicated (during the industry hearing on February the 17th) that the SA framework should put more weight on simplicity and comparability, and less on risk sensitivity. However, comparability and risk sensitivity are very much related, hence when addressing risk sensitivity more, the level of comparability will increase.
- In our view, the process of allocating capital to assets consists out of two important steps. First **all assets – no matter how different in shape or form – are ranked from low risk to high risk by using one single yardstick, namely the risk weighting allocation process**. Secondly, based on these risk weights a certain minimum amount of capital is required (e.g. CET1%). This consultation is focussing on the first step. Even though we focus on the SA framework (simplicity), we still think it is very important to rank all assets in the best possible way, without making the framework too complex.
- In our response we repeatedly make the point that the risk weights seem too high (or too low) for a certain type of asset. If so, we refer to the first step as explained above, suggesting to improve the ranking of assets from low risk to high risk. We do not refer to the amount of capital required given a certain risk weight.

Areas of concern and suggested improvements

External Credit Ratings:

1. In line with the consultative document we think it is important to have a robust **due diligence process** around the usage of external ratings for capital requirements. However, we see no reason of issuing (detailed) due diligence guidelines. Instead the current Pillar 2 (ICAAP/SREP) processes could be aligned on this subject, to ensure comparable due diligence processes, in order to prevent too different levels of conservatism applied in these due diligence processes, which could lead to significant differences in risk weights, although the underlying external ratings are similar.
2. In 2000 the BCBS published the **Principles for the Management of Credit Risk**, in which guidance is provided regarding ensuring a sound credit granting process, monitoring process and adequate controls over credit risk. Most jurisdictions have incorporated these principles and are yearly reported upon and reviewed in the Pillar 2 (ICAAP/SREP) processes. That is why we see no reason of issuing detailed due diligence guidelines. Instead the current Pillar 2 processes could be aligned on this subject, to ensure comparable due diligence processes.
3. For externally rated exposures we are of the view that due to the limited amount of buckets, the cliff effect is too large. Also when comparing the IRB risk weights with these proposed SA risk weights we see that the SA framework leads to a significant increase of capital requirements. We understand that the SA framework is less risk sensitive and a buffer for conservatism is justified. However, to ensure a minimum level of comparability, we suggest to increase the number of buckets and slightly lower the risk weights of these buckets. **By creating more buckets the risk sensitivity will increase** and the risk weight consequences of the due diligence process would become more relevant. In line with the proposed buckets by IBfed during the Industry Hearing in Basel on 17 February 2016, we support the following suggested structure:

Rating grade	Investment Grade				Non Investment Grade		
	AAA	AA+ to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ to B-	Below B-
Bank exposure "base" RW:	20%		50%		100%		150%
Corporate exposure "base" RW:	20%	50%		100%		150%	
Suggested "base"RW for Bank and Corporate exposures	[20%]	[25%]	[30%]	[50%]	[100%]	[125%]	[150%]
SCRA*: Unrated Bank exposures "base" RW	50%			100%		150%	
SCRA: Unrated Corporate exposures "base" RW	75%				100%		
Unrated RW for Corporates and Banks	100%						

* SCRA = Standardised Credit Risk Assessment Approach

Table 1

Banks:

4. **Implicit government support.** Paragraph 17 of the consultative document states that the external rating must not incorporate assumptions of implicit government support. We acknowledge that governments should no longer provide implicit support to their (commercial) banks. This is exactly what is being addressed with the introduction of Recovery and Resolution standards, including TLAC (and locally MREL, resolution funds and deposit guarantee funds).

Hence, it is the actual implicit support that should be and is being addressed, rather than excluding it from the capital requirements. In our view external ratings should reflect the actual risks, that is what they should continue to do. The implicit support expressed in external ratings is already significantly reduced and this process will continue as the Recovery and Resolution standards are in the process of being phased in (or built up) in the local jurisdictions. Hence, we strongly suggest that the external ratings continue to reflect the actual risks.

5. **Short term bank exposures.** Paragraph 18 of the consultative document states that exposures to banks with an original maturity of three months or less can be assigned a preferential risk weight. From a risk point of view it makes sense to extend the short term preferential treatment up to 1 year maturities. Because it would also fit well into other parts of the overall Basel framework such as the NSFR and TLAC.
6. From both a comparability and a risk sensitivity point of view it makes sense to risk weight two identical exposures to the same counterparty with both residual tenors of two months identical. Capital is allocated for unexpected losses in the future, irrespectively whether these exposures have been in the books for just one month or already for one year. We suggest to make the short tenor preferential risk weight applicable to all **residual maturities** up to 1 year.

Corporates:

7. **Unrated corporate exposures.** In Europe less than 1% of the corporate clients, representing less than 10% of the exposure, have external ratings. Therefore the vast majority of the corporate book is unrated and would get a flat risk weight of 100%. Allowing the SCRA approach will (for unrated investment grade corporates) remove the significant cliff effect once a Corporate SME client would grow-out of the asset class (due increased turnover), after which the client becomes an unrated (non SME) corporate client and will be risk weighted 100% instead of 85%.

Therefore, for unrated corporate exposures, **we suggest to make the SCRA approach** – the concept of investment grade and non-investment grade – **also applicable to jurisdictions that do allow the use of external ratings**. Be it without the requirement of having securities listed at a recognized securities exchange, as this would close the door for almost all European unrated corporates.

Specialised Lending:

8. Almost none of the specialised lending exposures have issue specific external ratings, hence almost all of these exposures will receive the proposed flat risk weights [120% / 100% or 150%]. The Standardised Approach risk weights for the specialised lending exposures seem to focus mainly on the probability of default (PD) side (which partly could explain the proposed high risk weights), while the actual specialised lending risk profiles are to a large extent based on the (non-financial) collateral and non-collateral risk mitigating structures on the loss given default (LGD) side. Specialised lending exposures are subject to tightly managed, self-liquidating and/or secured structures. For many years, the institutions have invested in in-depth product and client knowledge, robust (risk management) processes, monitoring & controls and transaction structures, which led to very low losses that are reflected in the IRB risk weights.

All exposures – no matter how different in shape or form – should be ranked from low risk to high by using one single yardstick, namely the risk weighting allocation process. As calibrated in the second consultation document, the risk weights for specialised lending exposures are on average significantly higher compared to unsecured lending to unrated corporates. The proposed risk weights clearly conflict with this ranking principle.

We suggest to re-calibrate the proposed flat risk weights and to introduce alternative methods to allocate risk weights that better reflect the actual risk profiles while keeping the Standardised Approach framework fairly simple.

9. Aspects to consider in the re-calibration:
 - The Dutch Central Bank (DNB) performed an internal study in which they estimated that for the largest three Dutch banks (ING, Rabo and ABN AMRO) the risk weights could go up a factor three to four (from their current IRB risk weights to the proposed SA risk weights). Such a potential significant risk weight increase will not only affect the banks: volume and profitability, but also the economy: pricing, availability (again: volume) and a potential shift of supply from regulated banks to financial companies that do not have equally sound risk management processes, with the risk of higher losses, leading to economic volatility. The IRB models predict expected losses. These predictions are being back-tested annually to observed losses. These inputs that go into the IRB risk weight calculation should be considered as sufficiently correct, considering all the tight supervisory scrutiny around it.
 - In the re-calibration process, the ranking of all banking assets, from low risk to high risk should be taken into account. In such a ranking the bulk of all specialised lending exposures should be ranked as lower risk compared to unsecured corporate lending and should receive a lower risk weight accordingly.

- In 2015, the European Banking Authority (EBA) published a consultative paper² regarding the slotting approach under the European Capital Requirements Regulation. EBA provided evidence that 70% of all the European specialised lending exposures for which the slotting approach was used (for approx. 45 European banks, representing approx. € 238 bln of specialised lending exposures), received risk weights between the 50% and 90% (slotting categories 1 and 2). These risk weights are significantly lower compared to the BCBS proposed SA risk weights and even lower compared to the corporate unsecured (unrated) risk weights (100%).
- Besides IRB data, we recommend the BCBS to consider taking into account pooled data from data consortiums like the Global Credit Data (GCD) consortium, for credit default data collection for shipping, commodity finance and project finance.
- Finally, we recommend to take notice of the AFME discussion paper (DP / DEC 2015) on the capital treatment of commodity finance, which can be found on www.AFME.eu. Several Dutch banks contributed to this DP. The paper puts the BCBS proposals into perspective against the risk mitigating structures and the historically low losses.

The following table provides an overview of the different methods: the risk weights under the slotting approach, the current average risk weight under the IRB approach for the three largest Dutch banks, the risk weight under the current SA and the risk weights under the second proposed SA revision.

Total IRB Exposures (European banks, in € x bln, 2014, Q3)	100%	
A-IRB 496	48%	(based on PD, LGD and EAD models)
F-IRB 290	28%	(Based on PD models; LGD and EAD are not modelled)
Slotting 238	23%	(RW is based on detailed questionnaires)

Slotting (for 45 European banks)	Category 1	Category 2	Category 3	Category 4	Category 5
Exposure weighted distribution	34%	36%	11%	4%	15%
Risk weights for remaining Maturity: Less than 2.5 years	50%	70%	115%	250%	0%
Risk weights for remaining Maturity: Equal or more than 2.5 years	70%	90%	115%	250%	0%

Current SA RWs (all specialised Lending exposures)	100%
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Second SA revision proposal	
Object or Commodity Finance	120%
Pre-operational Project Finance	150%
Post-operational Project Finance	100%
If there is an Issue specific external rating	[20% - 150%]

Table 2

² CP for the draft RTS on assigning risk weights to specialised lending exposures (11 May 2015)

10. Alternative methods to allocate risk weights:

- First of all we suggest to allow the slotting approach to be used under the SA framework³. Allowing slotting under SA would increase the risk sensitivity and therefore the comparability: comparable risks would receive comparable risk weights. The slotting approach rewards solid structures over weak structures. It would bring the SA capital requirements more in line with the risk assessment and processes of risk management.
- Alternatively, we suggest to allow the Standardised Credit Risk Assessment Approach (SCRA) to be used also for specialised lending exposures. In line with the SCRA for unrated counterparties, based on several risk sensitive criteria the specialised lending exposures could be bucketed into an A, B (or C) grade. The criteria for SCRA to specialised lending could be taken from a selection of the questions within the slotting approach. According to the scores on those criteria, the specialised lending exposures could receive risk weights that better reflect the actual risk profiles. If such a structure is allowed under banks and corporates, it should be feasible to make it work for specialised lending exposures too.
- Finally, to the extent not already reflected under a slotting or a SCRA approach, we recommend that under the Standardised Approach, non-financial collateral should be recognised as an eligible form of Credit Risk Mitigation. For all specialised lending exposures, especially for commodity finance and object finance exposures, certain non-financial collateral types, for which market values are available, should be taken into account to lower the risk weighted asset using an appropriate supervisory hair-cut.

Both a significant re-calibration of the proposed risk weights and the introduction of alternative methods are crucial steps towards a robust and acceptable SA framework for specialised lending. Both should lead to a better translation of the actual risks into the risk weights.

³ Under the slotting approach a number of questions need to be answered, related to the financial strength, the political and legal environment, the transaction and or assets characteristics, and the strength of the sponsor and the developer, including an assessment of the income streams and security packages. Based on the answers to these questions the specialised lending exposure will be placed in one of the five categories (ranking from less risky to very risky). From a risk management point of view, but also from a capital requirements point of view, the questions seem to be very relevant to assess the risks of the specialised lending exposures.

CCFs:

11. The credit conversion factors (CCFs) for unconditionally cancellable commitments (UCCs) to non-retail clients seem significantly incorrect. We suggest to ensure isolating the UCCs to non-retail from all the other CCFs based on an unambiguous set of definitions. In the current SA framework, translated into European legislation (CRR, Annex I) the UCCs are labelled as low risk items receiving a zero percent risk weight. We trust that a closer look into the QIS data, (again) based on an unambiguous set of definitions which clearly separate the UCCs to non-retail from the other off-balance sheet commitments, can only lead to a CCF for UCCs to non-retail close to zero. In line with the current SA framework, IFRS does not recognise the UCCs and therefore does not translate these into an off-balance sheet item that from a risk perspective is not worthwhile to disclose.
12. For the sake of comparability and risk sensitivity, we strongly believe that similar risks should get similar risk weights, and different risks should get different risk weights. In this light, if (QIS) data show significant differences per jurisdiction, these differences should be translated into different CCFs. Then, we suggest that the BCBS could set minimum standards, allowing local supervisors to increase the CCFs for their jurisdictions in line with the observed data.

Real Estate:

As from paragraph 13 to 19 we listed our main concerns and suggestions related to residential real estate exposures. In Annex 1 we provided more background information and examples regarding this exposure class.

13. We believe that similar risks should lead to similar capital levels, while different risks should lead to different capital levels. Based on records of payments, past due and defaults on mortgages we observe that an 80% Loan to Value (LTV) in a mature and stable jurisdiction reflects a different risk profile compared to an 80% LTV in an emerging market jurisdiction. We do support the use of LTV as risk driver for residential mortgages (and buy-to-let). We emphasize however that LTV is a valuable risk driver within jurisdictions, but it a poor risk driver across jurisdictions. Any risk weight for real estate, which does not take into account local circumstances, is deemed to fail. In the appendix we listed several explanations for these differences across jurisdictions.
14. Therefore, we consider that it is not justified to use a single global risk weight for these same LTVs for which the underlying actual risk profiles can be so very different. A one-size-fits-all LTV based risk weight allocation method could create a significant mismatch between actual and measured risk (reducing risk sensitivity) and would thus provide an incentive for (adverse) risk selection. This would *weaken* bank balance sheets, completely contradictory to the objective. Also different risks (which might have similar LTV levels) would have similar capital requirements, which reduces the comparability.

In our view a **significant re-calibration of risk weights** is therefore required for residential real estate loans. Local housing markets differ significantly, this fact we cannot ignore. Hence, these differences justify local calibration of risk weights. The local calibration processes could be supervised by a central body, in line with the supervisory process around the countercyclical buffer. In case Basel nonetheless does not wish to allow national calibration, Basel should aim for minimum capital standards that fit the most stable and mature housing markets. Local regulators supervising a more risky housing market could set higher risk weights accordingly.

15. Both the current SA framework and the current IRB framework facilitate periodical property value adjustments. It is an important feature that adds risk sensitivity and therefore comparability to both frameworks. When fixing the LTV at origination as proposed by the BCBS, during the lifetime of the transaction – as the intrinsic value might change significantly – the assigned risk weight most probably loses its link to the actual risk profile and also its link to the risk management processes. Related to all real estate exposures (hence residential and commercial), we suggest to allow **periodical property value adjustments** to be factored in the LTV calculations. This would increase the true comparability by increasing the risk sensitivity, without making the framework unduly complex. The supervisors have multiple effective tools to their disposal to prevent house price bubbles to be factored into the LTV calculation (e.g. impose downward value adjustments; increase risk weights, or increase countercyclical buffers).
16. **Loan splitting** should be allowed. It will remove undesired cliff effects and would create a more level playing field. It would increase risk sensitivity and therefore comparability, as almost similar LTV levels (within a jurisdiction / based on local calibration) which currently would sit in different LTV buckets (e.g. LTVs of 79% and 81%) represent almost similar risks, and – based on loan splitting – would have almost similar capital requirement. (synthetic⁴) Loan splitting is not a complex process.
17. Under the current European Credit Risk Mitigation (CRM) regulation, certain covers, like cash, can reduce the exposure amount through netting. However, in the current BCBS proposal, these covers shall not affect the LTV calculation, while a partial repayment of the principal does affect the LTV. We kindly request to remove this inconsistency. If a cover is recognised under the CRM chapter, it should be taken into account in the calculation of both the exposure amount and the LTV.
18. **Buy to let.** First we endorse the differentiation between the risks of loans to buy-to-let (BTL) residential properties:
 - For which the repayment does not materially depend on the cash flows generated by the property, and
 - For which the repayment materially depends upon the cash flows generated by the property.

⁴ Synthetic refers to the fact that actual loan splitting towards the client is not required. The clients receives a single loan. This single loan is splitted just to determine the risk weight.

The first category of loans is subject to the same risk weights as loans to owner occupied residential properties, whereas the second category (henceforth abbreviated as BTL) is subject to higher risk weights. However, compared to the current SA framework the risk weights for BTL loans show a disproportionate steeper increase compared to other real estate linked risk weights. The applicable risk weights in paragraph [56], table 10, are even higher than the risk weights for commercial real estate (CRE), as in paragraph [58], table 11. The first QIS data does not support such an increase.

The risk on BTL loans is perceived higher, because of the dependence on the rental income. However, in contrast to CRE loans, in most jurisdictions the market value of residential properties increases in case of vacancy (e.g. because of strict tenant protection). Therefore we argue that, while the risk weight for BTL could be equal to or higher than the risk weight for residential mortgages, it certainly should be lower than the risk weights for CRE loans. Thus again we stress the importance to allow for local differentiation, as local circumstances are essential in determining the risk of such loans.

Therefore we suggest the following alternative approach:

In line with the current practice in Europe (as laid down in the CRR, articles 124 & 125), the minimum risk weights for BTL exposures could be set equal to those of owner occupant based exposures that meet the Requirements (as per paragraph 50), and thus ignoring article 56. Then, the competent authority could be mandated to set higher risk weights in their jurisdiction, if deemed necessary (based on historical losses and or forward looking market developments), but capped to the risk weight for CRE loans. This would fit into the BCBS objective of setting minimum standards.

19. **For residential mortgages where the Requirements in paragraph [50] are not met**, the BCBS proposes a risk weight of 100%. This is more punitive than unsecured lending to the same retail client. For those residential mortgages that do not meet these requirements, we suggest to increase the risk weights in table 9 with a certain risk weight add-on. In this suggested approach the risk sensitivity through LTV differentiation would stay, be it with increased risk weights. Alternatively, a flat risk weight of 75% should be made applicable (instead of a risk weight of 100%).

The SA framework in a broader context

20. The SA framework related to credit risk is not only relevant to institutions that report their credit risk assets on SA. It is also relevant to IRB institutions through the proposed Capital Floor (see paragraph 21 to 24 of our response).

Next to the Capital Floor, the SA framework for credit risk is very relevant for the liquidity requirements as the LCR and the NSFR have many references to the SA based risk weights. Therefore we kindly request the BCBS to update the **LCR and NSFR** framework in order to ensure a liquidity neutral impact caused by the proposed SA revision. Also, the exposure calculation based on the SA framework is very relevant to the **Leverage Ratio**. The revision of the SA framework (especially related to CCFs) might have a material impact on the Leverage Ratios for many institutions. Finally, this SA revision might also have an impact on **TLAC (and**

MREL) as TLAC (and MREL) are also based on risk weighted assets. All in all we request the BCBS to neutralise unintended impact on these other parts of the Basel standards.

Capital Floors:

21. Because the SA framework might seriously impact capital requirements for IRB portfolios through the intended introduction of a SA based Capital Floor, we are concerned about the impact of possible proposals in this area.
22. In the Netherlands many institutions report a very high percentage of their assets on IRB. Also, for many portfolios the historical losses are relatively low, due to the mature and stable nature of our markets. This is captured by the various IRB models and translated into relatively low but realistic risk weights compared to SA. The proposed Capital Floor, if calibrated above the 50%, would ignore the actual risk profiles and ignore the IRB outcome to a large extent. We are very concerned by the high impact of such a generic and non-risk sensitive measure. It would in a sense also reduce the actual comparability of risk, as only the outcome (risk weights) would become more comparable, whilst the input (the underlying actual risks) differs significantly. It will lead to a lack of coherence between risk management and regulatory capital requirements, and frustrate the transparency of risk disclosures to financial stakeholders.
23. A Capital Floor would have a number of unintended negative side effects, namely:
 - There will be a reduced incentive to reduce risk through product structuring (i.e. the inclusion within loan arrangements of certain risk mitigating features such as collateralization or use of trade finance type structures).
 - Within a risk category, there would be an incentive to increase economic risk (and increase income) per unit standardised Risk Weighted Asset (RWA) wherever a capital floor bites.
 - Banks will have reduced incentives to improve risk frameworks or maintain risk models in some areas if the output of models is overridden.
 - Adjusting RWAs would make it much more difficult to compare RWA levels, and in particular, understand RWA projections from banks in, for instance, future EBA stress tests.
 - If Capital Floors have a direct impact on Common Equity Tier 1 ratio (CET1%) metrics then this could have significant unintended consequences for triggering of contingent capital instruments.
24. Finally, if the BCBS would propose floors on internal rating based models (input floors on LGD and PD), there is no justified reason to introduce a SA based capital output floor next to the non-risk sensitive Leverage Ratio. Therefore we request the BCBS to reconsider the introduction of a SA based Capital Floor.

Annex 1: Residential mortgages

The Dutch banks believe that the following adjustments to the second consultation document would make the framework fit for its purpose:

1. Local calibration of risk weights
2. Property value adjustments should be taken into account
3. Loan splitting should be allowed
4. Covers that are recognised under the Credit Risk Mitigation chapter (like cash covers) should be taken into account when calculating the LTV

1.1. Ad 1. Local calibration

Housing markets are very different:

In general, residential mortgage portfolios are portfolios for which ample data is available to substantiate risks in a statistically significant manner. This data shows significant differences between local housing markets and jurisdictions, even for comparable LTV levels.

Reasons for these differences:

The most relevant reasons for these differences of risks of local housing markets are explained by differences in:

- **Social welfare systems:** to what extent does unemployment negatively influence the ability to pay?
- **Underwriting criteria:** Dutch law specifies strong underwriting criteria for mortgage owners. This means that for the same LTV and debt-income ratio, the ability and the willingness to pay are higher in the Netherlands than in peer markets.
- **Legal regime - time to foreclosure:** Dutch law allows banks to quickly foreclose properties in recovery – typically between 12 – 18 months, whereas the time to foreclose in other peer markets can be up to 5 years where legislation is driven towards protecting the borrower. This difference alone can halve the present value of recoveries and correspondingly has a large impact on Loss Given Default values (LGDs). In addition, foreclosure does not relieve the borrower of the obligation to repay the (remainder of) the debt (full recourse).

These differences are also expressed in IRB models

Firstly, under the internal rating based (IRB) approach expected losses are estimated through the Probability of Default (PD) models, Exposure at Default (EAD) models and Loss Given Default (LGD) models. These models are scrutinised and approved by the competent authority before they can be used under the IRB approach. Through BCBS based formulas laid down in law (Europe: CRR), the expected loss is scaled up to an unexpected loss amount, which is the input for regulatory capital. These BCBS formulas are equal for all institutions.

Internal models (PD, LGD and EAD) that estimate expected losses can easily be back-tested against realised performances, this back-testing already takes place on a periodical bases. If the performance – through supervisory scrutiny and or based on back-test results – would not be up-to-standard in a given period, these models are updated in such a way that the performance is immediately lifted to adequate levels, and would become fit for intended use.

Due to checks and balances, both internally (Monitoring / Back-testing / Model Validation) and externally (supervisory controls and approval processes), it is in our view fair to state that the outcome of these internal models is sufficiently adequate. Even though there is some degree of unintended risk weight variation amongst internal models (such as levels of conservatism and application of downturn in data series, which the industry is willing to address). The Dutch banks are also open to further debate about the underlying assumptions of models, the use of data, and the way how risk are modelled. We believe it is not justified to simply state that internal models significantly underestimated risks, as such statements are being heard in some instances.

A more than doubling of risk weights in the Netherlands for IRB portfolios and a significant risk weight increase for SA portfolios (mostly due to the LTV fixed at origination) is simply unacceptable and will impact the interest rates that customers will have to pay for their loans used to acquire retail real estate. QIS results will make transparent that this is an overshoot for many mature and stable jurisdictions leading to all sorts of negative consequences for these markets. This cannot be ignored and such consequences should be reduced significantly in order to introduce a trustworthy framework and a level playing field.

Current SA misses a minimum degree of risk sensitivity: local calibration is key:

The BCBS indicated (during the industry hearing on February the 17th) to put more weight on simplicity and comparability, and less on risk sensitivity. However, comparability and risk sensitivity are very much related. Equal risk weights may give the impression of comparability, but applying equal risk weights to essentially different risk profiles in our view provides a false sense of comparability, due to a lack of risk sensitivity. Therefore it is key to increase risk sensitivity without making the framework unduly complex.

We suggest that the BCBS considers two alternatives.

- Firstly setting the risk weights at a certain minimum level based on a set of jurisdictions that have mature and stable housing markets. The Basel jurisdictions that consider their housing markets as more risky could set higher risk weights accordingly. The current Basel framework as well as the current European CRR facilitates local competent authorities to set higher risk weights.
- Secondly, the BCBS could decide for (for example) three risk weights tables, one table represents a full mature and stable housing market, the second would represent an average risky housing market, the third would represent a more than average risky housing market. The competent authority determines which risk weight table should be used per jurisdiction. In this way the approach is quite similar to the current process around the countercyclical buffer: locally initiated with central controls and a solid disclosure process around it. Of course this also requires an unambiguous set of criteria on which the conclusion is to be based that a market is stable/ mature or not. We have elaborated this below, and we would welcome the opportunity to further exchange views about this.

The housing markets could be bucketed into three categories:

1. Lower risk (stable market)
2. Medium Risk
3. Higher Risk (less stable market)

The three categories could have dedicated risk weight tables:

Risk profile of Bank's portfolio	LTV < 40%	40% ≤ LTV < 60%	60% ≤ LTV < 80%	80% ≤ LTV < 90%	90% ≤ LTV < 100%	LTV ≥ 100%
Low Risk portfolio						
Medium Risk Portfolio <i>[BCBS proposed risk weights]</i>	25%	30%	35%	45%	55%	75%
High Risk Portfolio						

Table 3

Based on a list of criteria, the national competent authority could rank the local housing market in one of the three categories. Periodically a re-assessment could be made in order to ensure that the housing market is placed in the correct category.

The list of criteria could include:

- The local criteria to determine the degree of the ability to pay (especially for higher LTV loans)
- The average level of defaults (with a harmonised EU definition; any definition for that matter that is widely accepted and for which the reliable data are available)
- The development of the house prices (index)
- The time to foreclosures (again: a standardized measure)
- The underwriting criteria

To ensure transparency and consistency it can be envisaged that the competent authority discloses its assessment and a global institution (under the supervision of the BCBS) has a mandate to ensure consistency in the ranking of national housing markets.

1.2. Ad 2. Periodical property value adjustments

A prudential capital framework should not be pro-cyclical, and should thus - amongst others - be protected against the risk that house price bubbles could lead to lower capital requirements at times the capital cushions are needed the most. Hence, ideally intrinsic value adjustments should be taken into account when periodically updating the LTVs.

There are multiple safeguards already built in or being built in, in order to prevent house price bubbles to muddle a realistic LTV:

- The second BCBS consultation document allows local supervisors to downward adjust house prices in case of need (article 52).
- Also, in the current Basel SA framework – and also in the current European legislation (CRR, article 124) – the competent authority can increase the risk weights in case of need (or even the LGD floors for IRB portfolios).
- In Europe, banks are required to apply strict criteria for the valuation of property (CRR art 208).
- Finally, in case of overheating the countercyclical buffer could be activated or increased. The countercyclical buffer was invented just to act on these kind of possible asset price developments.

All in all, there are several safety measures in place to allow for a prudent reflection of intrinsic property value adjustments. A prudent value adjustment would make the SA framework more comparable, as it would better align the capital requirements with the actual underlying risks.

A framework in which the house price values are periodically prudently updated, more easily facilitates downward value adjustments. Why? Well, there would be less complexity around determining downward adjustments per vintage. Also periodical property value adjustments removes potential complexity – if the competent authority wishes to downward adjust house prices – in case of individual house value adjustment due to renovation projects.

In case the value of the house was fixed at origination, per mortgage loan – depending on when the loan was initiated, and what the prudent value adjustment might have been, the proper calculation of a downward adjustment would have been required. All this would no longer be required, if the house price would have been updated periodically. A downward adjustment would follow the same periodical process (but then with a negative adjustment result).

Also, house price developments show regional differences, which, in case the supervisors wishes to downward adjust house prices that are based on valuations at the start of the loan, the downward adjustment should take into account these regional differences.

In case the competent authorities are of the view that a periodical house price increase is (partly) based on overheating (inflating a bubble), the observed periodical adjustment can be overruled (smoothened) before being processed in the capital calculation process. Hence, a yo-yo effect can be prevented, which supports a more stable capitalisation process. This would be beneficial above a one-direction downward price correction imposed by a competent authority. Even a “no objection” requirement from the national supervisor could be considered.

In the annual Pillar 2 (ICAAP / SREP) processes institutions should convince their competent authorities that their databases and their (senior) management decision processes regarding the

house price updates are sufficiently prudent and robust which safeguards conservative house price adjustments.

Both the current SA framework and the current IRB framework facilitate periodical house price adjustments. It is an important feature that adds risk sensitivity and therefore comparability to both frameworks. If the revised SA framework no longer allows periodical house price adjustments the actual capital impact from the current SA framework to the revised framework becomes even larger. For a proper impact analysis, institutions should swap their up-to-date LTVs (which they currently use for capital calculations) and dig up the original LTVs. As mortgage loans often have tenors of 20 to 30 years, institutions might need to go back multiple decades. Over a long period of time, including house price drops, on average house prices are upward sloping, therefore the capital impact – if LTV at origination is to be used – could be very significant.

If the LTV is to remain fixed at origination, multiple challenges would undermine a level playing field:

- In case of significant intrinsic house price increases both institutions (capital driven) and households (price driven) would have the incentive to close the mortgage loan and initiate a new loan based on a new LTV calculation. The operational burden could then lead to very different capital requirements for similar risk profiles (while the one mortgage loan is terminated and re-initiated, another client might stick to his original loan).
- (small) renovation to the house could lead to significant differences in capital requirements, see example 1, on the next page.
- Also comparable risks will receive different risk weights, see example 2.
- Finally, there is the risk of differences in the national processes of imposing downward price adjustments by national competent authorities, which will lead to an unlevel playing field.

These unintended capital variations can easily be avoided. Periodical value adjustments increase the risk sensitivity and therefore the comparability of the SA framework, without making it unduly complex.

Example 1: renovation work and periodical price adjustments

Rightfully so, in case of renovation work to the property (e.g. new kitchen) the second BCBS Revised SA CD allows the LTV to be updated accordingly, also for regulatory capital calculations. However, if the BCBS would decide to keep the value of the property in the LTV calculation fixed at origination for all other cases, strange anomalies will take place. Please consider the following example:

There are two identical houses, in the same street. Two families (The Adams' and the Brown's) bought these houses in the same year, in 2010. They both took bank loans of € 250.000. In 2016 the Brown family renovated their kitchen. The Adams decide not to renovate. As per end 2016, the Brown family ends up with a lower LTV and therefore benefits from a lower monthly mortgage interest payments (due to risk sensitive pricing grid) and the bank that has the Brown's mortgage loan on the book sees a drop in risk weight in line with the drop in actual risk (substantial house price increase over the last 6 years).

LTV at origination issue	The Adams family	The Brown family
House price in 2010	260.000	260.000
loan in 2010	250.000	250.000
LTV at origination	96%	96%
Intrinsic value increase over last 6 years	12%	12%
	31.200	31.200
Amortisation over the last 6 years	40.000	40.000
Additional loan for renovation (new kitchen, 2016)		10.000
Value increase due to renovation (new kitchen, 2016)		10.000
Original house value	260.000	260.000
Intrinsic value adjustment	31.200	31.200
Value adjustment due to renovation	-	10.000
Value to use in LTV calculation	260.000	301.200
Original loan amount	250.000	250.000
Amortisation over the last 6 years	-40.000	-40.000
Additional loan for renovation	-	10.000
Total Loan amount	210.000	220.000
LTV in 2016 (used in capital calculation)	210000 / 260000 81%	220000 / 301200 73%
RW as per 2016	45%	35%
RWA as per 2016	94.500	77.000

Table 4

For almost similar risks (the two houses), the risk weights will deviate substantially, and the higher mortgage will receive lower RWAs, just because of the renovation. The difference in capitalisation is more driven by the fact that after a renovation the intrinsic value adjustments can be factored into the LTV calculation, while without a renovation it may not. We kindly advice the BCBS to allow for intrinsic value adjustments (upwards and downwards).

Example 2: LTV at origination lowers comparability

In an average street in an average town, the houses were built in one large project. The houses are very similar and would be valued similar (market value).



In 2016 three neighbouring families could have significantly different risk weights, while the actual risks are very similar:

<i>The first family bought their house in 2000:</i>	<i>The second family bought their house in 2002:</i>	<i>The third family bought their house in 2015:</i>
<i>Loan amount: € 200.000</i>	<i>Loan amount: € 200.000</i>	<i>Loan amount: € 200.000</i>
<i>Value at origination: € 195.000</i>	<i>Value at origination: € 217.500</i>	<i>Value at origination: € 255.000</i>
<i>LTV: 102%; RW: 75%</i>	<i>LTV: 92%; RW: 55%</i>	<i>LTV: 78%; RW: 35%</i>

Table 5

In 2016, three neighbouring families live in very similar houses having identical mortgage loans, however, the regulatory capital that is based on a house price value at origination leads to very significant difference in risk weights, which leads to a complete lack of comparability and different pricing levels. In this example we excluded periodical repayments because we wanted to focus on the unintended impact that the different property values (for those different moments in time) could have, in case we would be obliged to fix the property prices at initiation. Nevertheless, in case of periodical repayments this issue remains.

1.3. Ad 2. Loan Splitting

In the current SA framework the risk weights show a smooth upward trend for LTVs above the 80%. Also in the current IRB framework the risk weights increase gradually as an incremental unit of risk is added to a residential mortgage loan.

In the first and second SA consultations, however, a risk weight table per LTV bucket is proposed that has several negative side effects, while a solution for these negative effects is simple without creating a lot of additional complexity.

What are the negative effects of the proposed LTV bucket approach:

- **Cliff effect.** With just a small incremental increase or decrease in LTV, the risk weight for the whole exposure amount can jump up or down by even 29% (when moving from 80% LTV to 81% LTV). Such a significant capital change for a very small change in the underlying risk is undesirable. It also might lead to significant jumps in pricing grids, again without a corresponding jump in risk profile.
- Also the degree of comparability suffers, also due to the cliff effect. While LTVs of 61% and 79% get allocated a similar risk weight (35%) while the difference in LTV equals 30%. On the other hand an LTV of 79% and 81%, which differ less than 3%, would have a risk weight difference of 29% (from 35% to 45%). In both examples the degree of comparability is very low, because the risk sensitivity is not optimal.
- The current proposal will lead to different capital requirements in case a single institution grants the loan or multiple institutions provide part of the total amount (first lien, second lien, etc.). While the risk profile (client and house) are similar the capital requirements can be very different. Also in case another institution would hold a senior lien (first lien), then the institution holding the junior (second) lien would underestimate capital in case loan splitting is not allowed, while in case loan splitting is allowed (or mandatory), the correct level of capital can be allocated. It goes without saying that the risk of a first and second lien mortgage loan together should equal the risk when the loan would have been offered in one single loan. Again, these kinds of unintended negative side effects should be and can be avoided.

Also within a single institution, loan splitting will remove the cliff effect. Cliff effects bring all kinds of unintended incentives to all kinds of stakeholders. The house owner, would see a jump in pricing in case the LTV just exceeds a LTV boundary. The house owner might wish to lend the additional loan amount in a different form (Retail Other). This would blur the risk profile of the client. Also the bank could put more focus on the LTV bucket rather than on the needs of the client.

In order to remedy the issues above, loan splitting should be allowed. Loan splitting allows for an incremental risk view. Loan splitting aims to divide the exposure synthetically into parts for the sole purpose of risk weight calculation. This is similar to the income tax calculation which hundreds of millions of households can cope with: a single amount of tax is paid, while the underlying calculations are sliced into various tax-buckets. This is an example where an insignificant increase in complexity results in a significant increase in risk sensitivity and therefore increases the true comparability significantly.

1.4. Covers that are eligible under the Credit Risk Mitigation chapter should be taken into account in the LTV

In the Basel Credit Risk Mitigation (CRM) framework, which is translated into European legislation (CRR, chapter 4, Credit Risk Mitigation) eligible collateral are listed, which – under the SA framework reduces the exposure amount.

The exposure amount is one of the two ingredients to determine the Loan to Value (LTV), which – in turn – is the most relevant factor to determine the risk weight for mortgage loans.

In the consultative document, it is stated under article 52 that even if the cover is eligible under the current CRM rules, it shall not be factored into the LTV ratio calculation (text from the CD):

“Where guarantees or financial collateral which are eligible according to the SA’s credit risk mitigation framework are provided, banks may recognise these risk mitigants in their calculation of the real estate exposure amount. Notwithstanding, such eligible guarantees and financial collateral must not be factored into the LTV ratio calculation that will determine the applicable risk weight.”

If the cover is recognised as risk mitigant, it is our strong view that the lower risk profile should also be translated into a lower risk weight. The current text is not consistent with the BCBS view of the risk mitigation effect of the eligible covers. We strongly advice the BCBS to reconsider the text and remove this inconsistency.

1.5. Miscellaneous

The Requirements listed in article 50 are partly vulnerable for national discretions. In particular regarding the requirement “Ability of the borrower to repay” we see a danger that national competent authorities will translate the degree of ability to pay differently, which could lead to unintended variation of risk measurement within the SA framework.

Also the requirement of “Prudent value of the property”, which in itself makes perfect sense, is quite vulnerable to local translations which – again – could lead to unintended variation of risk measurement within the SA framework.

Finally, article 56 states that if the primary source of the cash flows would generally be lease or rental payments or the sale, of the residential property, the beneficial risk weight table (table 9) shall not be used.

Although we understand the principle behind this article, often – for many home owners – the primary source of repaying the mortgage loan when terminating the loan before the end of the original tenor, comes from the proceeds of the sale of the house. If we would interpret this article in this way, the complete mortgage books of almost all institutions should be forced to use table 10 (even if the requirements are met) or even a flat risk weight of 150%. We trust this interpretation is not in line with the intention of this article. Therefore we kindly request to adjust the text accordingly.