March 2016

EMF-ECBC POSITION PAPER IN RESPONSE TO THE BASEL COMMITTEE ON BANKING SUPERVISION'S SECOND CONSULTATIVE DOCUMENT ON THE REVISIONS TO THE STANDARDISED APPROACH FOR CREDIT RISK

EXECUTIVE SUMMARY

1. The European Mortgage Federation-European Covered Bond Council (EMF-ECBC)[1] welcomes the Basel Committee on Banking Supervision's (BCBS) new Consultative Document (CD) on the Revisions to the Standardised Approach for credit risk.

2. The new CD displays key improvements with regard to real estate exposures. Amongst which, three stand out:

   (i) **Revised taxonomy:** Real estate is now better defined covering all real estate exposures, including Income Producing Real Estate (IP-RE) and Land Acquisition Development and Construction (ADC);

   (ii) **Debt Service Coverage (DSC):** Is no longer a criterion for risk weights because of the challenges to define and calibrate a DSC ratio. DSC remains though as an operational requirement;

   (iii) **Use of external credit ratings:** The reinstatement of external ratings is welcomed by the Industry although the additional due diligence required by the CD could prove burdensome for lenders.

3. Some unsolved issues however remain outstanding:

   (i) Given the **diversity of global real estate (RE)** markets in terms of risk profile, generally speaking, a one-size-fits-all approach is not appropriate. As such national specificities are ironed out by the framework. National specificities, instead, should be taken into account in such a granular market as RE;

   (ii) The present **consultation & capital floors consultation should be seen together** as internal-rating based banks (IRB banks) will be impacted by this proposal too;

   (iii) In order to align risk weights with actual risk profile, lenders should have the **option to update the value of the property**. The option could be linked to the monitoring and/or revaluation requirement of the CRR.

[1] Established in 1967, the European Mortgage Federation (EMF) is the voice of the European mortgage industry, representing the interests of mortgage lenders and covered bond issuers at European level. The EMF provides data and information on European mortgage markets, which were worth over €6.9 trillion at the end of 2014. As of February 2016, the EMF has 19 members across 14 EU Member States as well as a number of observer members. In 2004 the EMF founded the European Covered Bond Council (ECBC), which is a platform that brings together covered bond market participants including covered bond issuers, analysts, investment bankers, rating agencies and a wide range of interested stakeholders. As of February 2016, the ECBC has over 100 members across 25 active covered bond jurisdictions and many different market segments. ECBC members represent over 95% of covered bonds outstanding, which were worth over €2.5 trillion at the end of 2014. The EMF-ECBC is registered in the EU Transparency Register under ID Number 24967486965-09.

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(iv) **The proposed risk weights lead to significantly higher SA capital charges** for higher loan–to-value (LTV) loans. This effect can be reduced by allowing **LTV calculation based on loan splitting**;

(v) **A more balanced approach is needed for income producing real estate as there** is no evidence that cash flow producing real estate is a generally riskier exposure;

(vi) **A fine-tuning of the operational requirements** is needed especially with regards to the recognition of guarantees and financial collaterals and the valuation basis and frequency;

(vii) There should be **consistency between risk weights across different exposure classes**, so that secured exposures are not penalised compared to unsecured exposures. Otherwise there is a risk that lenders decide not to request any collateral at all for higher LTVs.

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Interaction between Standardised Approach & Capital Floors for IRB Banks

1. The EMF-ECBC does not favour capital floors. Capital floors, whether as a continuation of the current transitional floor or as a new framework based on revised standardised approaches, will significantly reduce the incentives to move towards an IRB approach, which will lead to less risk sensitivity overall. Such a shift might generate a loss of information and a lack of coherence between capital adequacy requirements and the risk management in the institutions. The BCBS has announced that internal models could be even disallowed for some portfolios. Consequently, the greater risk sensitivity facilitated by modelled approaches could be effectively 'overridden' and replaced by the much reduced risk sensitivity provided by standardised approaches. As such, the risk sensitivity and the new calibration of the revised credit risk standardised approach could impact both banks using this approach and the ones using IRB modelled approaches. This makes the design and calibration of the standardised approach for credit risk extremely important.

2. There is a significant risk that IRB institutions with low-risk portfolios (and low risk weighting) will be unduly and unintentionally affected. This may certainly be the case for mortgage banks with high proportions of low-risk-weighted mortgage loans. There is a risk that currently well-capitalised institutions may come under great pressure as a result of technical, or political, methodology changes alone and for that reason may appear thinly capitalised.

3. The impact on a floor linked to the revised standardised approach is likely to be significant for especially low-risk business. If a permanent floor linked to the standardized approach is introduced it is key that the latter is amended to secure a much better relationship between capital requirements and risk. However, if a new floor is going to be introduced it is equally important that it is introduced with a separate public consultation.

4. Moreover, the EMF-ECBC would like to remark that the BCBS **Leverage Ratio** does prevent, as a backstop, excessively low capital levels using a non-risk based approach. The 'safety net' provided by the Leverage Ratio to risk-based capital requirements for credit risk should allow a greater emphasis to be placed on reflecting risk sensitivity in the standardised approach for credit risk, including jurisdictional / country specific factors and credit risk mitigation.

Residential Real Estate

5. Real estate markets are very diverse. Their diversity stems from social security systems, the legal framework for mortgages and cultural behaviour. These factors, and more, can have a significant impact on loss rates. It is important to have a risk weight system that acknowledges such differences. The EMF-ECBC suggests that the BCBS allow for the local calibration of lower risk weights by national authorities if local market conditions and loss rates can be documented to support such lower risk weights.

6. The **operational requirements** listed at paragraph 50 of the CD present a number of difficulties:

   (i) <u>Finished Property:</u>

   - Condition (i): The definition of the "a one-to-four family residential housing unit that will be the residence of the borrower (this does not include apartments within a larger construction project)" is based on an American standard (multi-family and not multi-family) which bears no relevance in large parts of the world. Phrased as such, this

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requirement will maintain the status quo in the US, where most people live in individual houses, whilst penalizing other jurisdictions, including the EU, where both individual houses and apartments are the norm. BCBS should take into account the diversity of the real estate markets in the wording of this condition.

- Condition (ii): This condition does not take into account alternative mechanisms for enforcing the conclusion of the construction. 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 a financial institution, and not a sovereign or a PSE. Yet, this mechanism clearly fulfils the spirit of condition (ii), 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. If this is the case, this interpretation should be made explicit.

(ii) Valuation**:**

- According to the CD, the BCBS is still proposing that the original value of the property, under normal circumstances, be used during the entire lifespan of the loan. The LTV would only be updated as the outstanding amount of the loan changes. The EMF acknowledges the BCBS' concern regarding the potential introduction of pro-cyclicality by allowing changes in property values to be taken into consideration, but it nevertheless believes that this approach is disproportionately penalising. A requirement to keep the value of the property constant as measured at origination in the calculation of the LTV would oblige lenders to ignore variations in property values over the longer term. The EMF-ECBC believes that the basic principle should be as follows: the numerator of the equation would be updated as proposed by the BCBS and there should be no obligation to update the denominator, i.e. the value of the property. Though, in order to comply with risk sensitivity requirements, a degree of flexibility should be introduced in the framework to provide lenders with the option to update the value of the property. Hence, lenders which choose to update both the numerator and the denominator of the LTV, should do so when it is justified by market developments. The valuation of the property should not require an on-site valuation. This flexibility could be linked to the monitoring and/or revaluation requirements of the CRR (Art. 208 CRR). This would ensure: (i) that risk weights are in line with actual risks and (ii) comparability of exposures.

- If the LTV will remain fixed at origination, multiple challenges will undermine the level playing field:

    a. In case of a significant intrinsic house price surge both institutions (capital driven) and households (price driven) would have the incentive to close the mortgage loan and originate 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);

    b. A small renovation to a house could lead to significant differences in capital requirements;

    c. Identical risk profiles will receive different risk weights. Two identical mortgages on two identical houses, in identical conditions, located one next to the other could

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have two different risk weights only because one loan has been originated after the other;

d. Finally, it will flatten out differences in the national competent authorities' processes of imposing price adjustments, limiting the overall subsidiarity and reliability of the system.

- When setting the requirements regarding the calculation of the LTV, the CD assumes that a valuation will always be available. In some markets, for example in France, the transaction price between buyer and seller is the best valuation available, which is why requiring a valuation for each and every retail mortgage loan is not a market practice in France.

(iii) Loans which do not meet the operational requirements:

- The current treatment of loans secured against residential real estate not complying with the operational requirements of paragraph 50 of the CD appears to conflict with the general principle stated in paragraph 104, according to which no secured loan shall receive a higher RW than an identical exposure without a lien.

7. Despite the obvious improvements in the treatment of real estate exposures, the fact that the revised BCBS proposal does not permit **loan splitting** remains a serious concern for the Industry. 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 splitting opportunities 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 raise costs with the registration of for example three loans instead of one loan;

(iii) **Introduction of significant cliff effects**: Particularly given the steepness of the increases in risk weights on the high LTV end, retention of loan splitting – 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 risk weight of the whole exposure.

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

(i) 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.

(ii) It makes the framework more risk sensitive without unduly increasing the complexity of the methodology.

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8. The proposal for real estate exposures will increase substantially the capital requirements relative to both the current standardized approach and IRB. These exposures are unduly penalised and capital levels go significantly beyond the risk shown by these products. This would have an impact on the cost of lending and therefore on the ability of the banking sector to provide credit.

9. In general risk weights would increase capital requirements for mortgages where repayments are not materially dependent on cash flows generated by property. The risk weight for these exposures is generally more than twice the IRB risk weights for the same exposures. This would increase the gap between capital requirements calculated under the standardized approach and IRB. Therefore, the EMF-ECBC suggests recalibrating the proposed risk weights in order to be aligned with the IRB risk weights and to reflect the real risk.

10. With all of these considerations in mind, the EMF-ECBC 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 EMF-ECBC 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 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

11. 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. This is because a sovereign will not in most cases recover loans on its own and will thus choose to pay after the recovery process is over. The important point should be whether the guarantee is unconditional, as opposed to when it pays.

Income Producing Residential Real Estate/Buy-to-Let

12. The EMF-ECBC is concerned about the significant difference in the proposed risk weights for mortgages where 'repayments are not materially dependent on cash flows generated by the property' of 25% - 55% and the possible risk weights for mortgages such as UK **Buy to Let mortgages** (where 'repayments are materially dependent on cash flows generated by the property') of 70% - 120%. In some jurisdictions such as the UK Buy-to-Let lending typically involves high financial quality landlords, where ultimate risk levels are regarded as being no worse than residential mortgage lending. Therefore, the EMF-ECBC suggest:

    (i) To include conditions which, if met, would allow the use of the lower regular mortgage risk weights for high quality Buy to Let lending;

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(ii) To increase the granularity of the risk weights at least with the granularity provided in table 9 because marginal increases in LTV would lead to significant increases in risk weights.

13. In many countries housing markets are traditionally characterized by a sizable rental market share. The higher risk weights for the so called Buy-to-Let imply a higher risk of this kind of business. The EMF-ECBC questions the premise that there is a higher level of losses in income producing vis-à-vis non-income producing real estate exposures in Europe. As a consequence, the highest risk weight does not seem to be supported by empirical facts.

14. In the case of some European jurisdictions, there have not been regulatory reforms on residential rental property during and after the financial crises making this segment riskier. Therefore, the EMF-ECBC invites to take due account of country specific differences. The national supervisory authorities should decide if there is a material dependency between the repayment of the loan and the cash flow generated by the property requiring a higher risk weight. Otherwise, the requirements in CRR article 125(3) should be maintained.

Commercial Real Estate

15. In its current proposal, the BCBS strongly penalises commercial real estate exposures. There is a poor recognition of the mortgage-enhanced security. Real estate secured exposures appear to be treated as a separate asset class. It is in fact hard to reconcile the discrepancies in the risk weights across classes of exposures. Commercial real estate exposures with a LTV over 80% receive a higher risk weight than unrated (unsecured) corporates exposures. Unless there is consistency between risk weights across different exposure classes, lenders may be incentivised to not request any collateral at all.

16. It is important to highlight that commercial properties are an important credit risk mitigation instruments for SMEs and the introduction of the proposed risk weights could have unintended consequences on SMEs role as a key driver of European growth. In fact, due to the new harsh conditions of the Standardised Approach, credit to SMEs might be squeezed. Consequently, the effects of this squeeze would be felt in the real economy.

17. The EMF-ECBC suggests, as for residential real estate, that local calibration of the lower risk weights by national authorities should be allowed if local market conditions and loss rates can be documented to support such lower risk weights.

Land Acquisition, Development and Construction (ADC)

18. The current wording of the CD suggests same risk weights for ADC exposures and past-due items. This treatment is not justified as often, in ADC projects, a significant proportion of the sales have taken place before the issuance of the mortgage. In such cases the exposure should be classified as CRE or corporate.

19. Moreover, the proposal leads to **counterintuitive results and could introduce perverse incentives:** a higher risk weight for secured exposures (which recognises the real estate collateral) than for unsecured exposures. A corporate mortgage on an unfinished property is always considered **land acquisition, development and construction** (ADC) and risk weighted at 150%, while unsecured loans to construction companies could have a lower risk weight according to the counterparty rating.

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20. The EMF-ECBC acknowledges that, in the past, in some countries, inadequate ADC risk management practices were in place. This said, the EMF-ECBC believe that **the proposed risk weight of 150% is not only disproportionate but also counterproductive. It jeopardises the ability of the entire construction industry to access funding. Needless to say, this industry is significant in terms of employment and is a major driver of growth**. The EMF – ECBC agrees that regulators should also look for a change of the incentives that lead to the last crisis, but keeping in mind the relevance of the sector in terms of growth at global level, thus avoiding measures that can harm the real economy.

21. The construction and commercial risks inherent to those loans may be largely mitigated depending on the legal environment prevailing in a particular jurisdiction; for example, a completion guarantee which a developer is required to obtain by law from a financial institution in some countries so that the buyer is not exposed to the risk of the developer defaulting before the construction is finished e.g. France, and which is offered in other countries e.g. Germany, is effective at reducing those risks and as a consequence a condition precedent to bank loans typically includes high levels of pre-contracted tenants or buyers (i.e. 40% to 50% pre-contracted buyers for a multifamily property construction loan), thus reducing uncertainty of cash flows.

22. The EMF–ECBC believes the BCBS should find a way to introduce risk sensitiveness in ADC exposures framework. From our point of view there are several ways to doing it and these should be explored by the Committee. Independently of the risk driver selected to best capture the inherent risk of this activity, the EMF-ECBC believes that the final framework should recognize the different mitigation practices that could be used to reduce the uncertainty of cash flows as mentioned in the paragraph above. A suggestion in this direction would therefore be **to allow national discretion,** for example, in the case of required completion guarantees. Anyway, any other effective risk mitigation techniques such as 'pre-selling' should also be recognised.

23. In case a significant proportion of sales does not take place before the issuance of the mortgage, another possible way of introducing a more risk-sensitive framework using traditional LTV, with some conservative haircut, is making a RWs matrix reflecting the increased risk in early phases of the construction process and a more similar risk to residential or commercial real estate when the building is finalised and ready to be sold. It does not seem justified **to have such large jump in RWs from property development to residential property at the time of the sale (as an example from 150% to 35% for a LTV of 80% in BCBS proposal**). That is, the Property Development should take into account the security value, with the tiering based on LTV.

Retail Exposures

24. The EMF-ECBC considers that the risk weight for retail exposures is not risk sensitive and **excessively punitive for good quality portfolios**. Therefore, the proposal could have **unintended consequences** as it would lead to a misrepresentation of the risk level and, subsequently, provide incentives for lower quality portfolios and inhibit the lending to the real economy. Therefore, the EMF-ECBC suggests increasing the granularity of the risk weights in order to reflect the borrower's credit quality. In this respect, the EMF-ECBC proposes to take into account additional drivers in order to enhance the risk sensitivity and to align it with the treatment under the IRB approach. For instance:

    (i) Variables directly linked to the behaviour of a particular product/customer. For instance it is necessary to identify separately qualifying revolving retail exposures as a sub-class within the retail asset class category. This segmentation would be consistent with the bank's practice segmentation of its retail activities and with the IRB approach;

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(ii) Variables associated with the length of the relationship with the customer. The maturity of the exposure. Both intuition and empirical evidence indicate that long-term unsecured credits are riskier than short-term credits. As a consequence, the capital requirement should increase with maturity.

25. There should be a specific supervisory treatment for loans to consumers repaid by the assignment of a proportion of a borrower's salary or pension (known as Cessione del quinto dello stipendio/pensione in Italy).

26. This technical form of consumer credit is supported by a series of guarantees that reduce the credit risk in comparison with other forms of retail loans.

27. In the case of Italy, these guarantees are:

    (i) direct assignment of one-fifth of the pension or salary to cover payment of the loan instalments;
    (ii) mandatory insurance policies ("life cover" for loans involving the assignment of one-fifth of pension and "life and loss cover" for transactions involving the assignment of one-fifth of salary);
    (iii) transfer of the effects of the assignment of salary to the pension when the borrower retires
    (iv) restrictions on availability of retirement bonus (trattamento di fine rapporto – TFR) and/or similar indemnities, with immediate recourse available to the creditor;
    (v) restrictions on possible attachments and seizures of the salary/pension that guarantee the privileges of the lender in comparison with other creditors.

28. Loans repaid by the assignment of one-fifth of a borrower's salary/pension clearly have numerous characteristics that mitigate risk. The low level of credit risk is supported by the outcome of a sample survey carried out by the Italian Banking Association (ABI) that, with reference to pensioners and public employees, showed that:

    (i) the probability of default (PD) within 12 months is 3.0%
    (ii) there is 32.6% return to performing status within one year
    (iii) the effective loss rate (weighted-average LGD rate) is 5.8%
    (iv) the expected loss (EL) is 0.16%.

29. Accordingly, the theoretical risk weight, calculated on the retail curve, is 8.4% (compared with the regulatory parameter using the current standard method of 75%). In view of this evidence, loans repaid by the assignment of one-fifth of a borrower's salary or pension should be recognised as loans that are less risky than other retail loans and merit a risk weight that is significantly lower than the current risk weight for the retail portfolio (75%). The EMF-ECBC suggests that the risk weights for these types of loans should be set at 35%.

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