

24th of June 2016

EMF-ECBC response to the Basel Committee on Banking Supervision Consultative Document on "Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches"

I. Executive Summary

1. **The European Mortgage Federation-European Covered Bond Council (EMF-ECBC)¹ believes that capital requirements should be founded on risk-based approaches**, which are an effective and flexible tool to gauge a bank's risk.

Output Floors

2. The EMF-ECBC is of the opinion that all the revisions of the capital framework (credit risk, market risk, operational risk) should suffice to achieve the Basel Committee's purposes and **there should be no need for output floors**.
3. **Floors are, in our opinion, hard to reconcile with a risk-based approach**. They might impede risk-sensitivity and even introduce perverse incentives leading to severe misallocation of resources.
4. In fact, **new capital floors, based on the Standardised Approach, will impact high quality IRB portfolios disproportionately**. For a number of financial institutions, this kind of new floors is likely to become the binding capital requirement, even calibrated at 60%.

Scope of use of internal models

5. The EMF-ECBC believes that **a fine-tuning of the IRB models can work better than removing the IRB approaches** for certain exposures or limit the use of A-IRB.
6. Rather than eliminating the possibility of choosing between IRBs, it would be much more appropriate to **harmonise internal methods, both for Advanced-IRB and Foundation-IRB**. This means further strengthening and harmonising of modelling assumptions and parameter definitions. In addition, we support setting up criteria for minimum data requirements to determine whether a parameter or portfolio is suitable for IRB modelling.

Specialised Lending

7. The concept of specialised lending should not include homogenous and common residential or commercial real estate exposures where abundant and reliable data is available, even if they share some of the features with specialised lending.

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.

8. A material increase in the level of capital required for BTL assets will imply to investors that they are more risky than residential owner-occupied mortgage lending. **Industry-wide historical arrears rates data in a number of markets show this to not be the reality.**
9. In order to reflect the different home-ownership cultures across countries and the relative strength of the BTL market in different jurisdictions, **the Basel Committee should allow national discretion, to permit competent authorities to allow BTL assets to continue to be included in the IRB approach.**

Parameter Floors

10. **The EMF-ECBC believes that A-IRB input floors will not properly address unintended risk weight variation.** Nevertheless, they could serve to address potential underestimation of risks, if the input floors are calibrated based on the data availability and the performance of the internal models. Then, input floors could be activated once underestimation of risk is proven.
11. Preferably, **the alignment of definitions and supervisory practices should be prioritised with respect to the introduction of parameter floors.**
12. We believe that setting global minimum values for parameter floors also undermines the investments made in developing best practices and risk measurement techniques. **As such parameter floors will disincentive banks from further investing in these sound risk measurement practices.**

II. General remarks

13. The EMF-ECBC welcomes the Basel Committee's new Consultative Document on *"Reducing variation in credit risk-weighted assets - constraints on the use of internal model approaches"*.
14. The EMF-ECBC believes that capital requirements should be founded on risk-based approaches, which are an effective tool to gauge a bank's risk. Decreasing the granularity in these approaches only reduces their ability to correctly estimate risk. The EMF-ECBC maintains this for a number of reasons:
- a. Risk sensitivity is essential to level the playing field from a risk/return perspective;
 - b. Granularity mitigates inefficient - or even perversely incentivised - lending behaviour;
 - c. Loss of granularity equals loss of information and hampers coherence between capital adequacy requirements and the risk management of financial institutions.
15. The EMF-ECBC firmly believes that, within risk-based approaches, Internal Ratings Based (IRB) models are fundamental. This is because:
- a. IRB models remain the best way to build awareness and understanding of risks both within banks and among supervisors;
 - b. IRB models, allowing granular, in-house produced estimates are also the best tool to adequately measure the risk of a portfolio of exposures, and therefore allocate adequate levels of capital against these risks.
16. Equally importantly, the banking sector is as interconnected as is diverse. A one-size-fits-all approach is not appropriate. Many business models which work very well for their own real economies thrive on their diversity and the more granularity is shunned from credit risk models, the more these business models will face problems to stay competitive.
17. The EU's Capital Requirements Regulation reads: *"The provisions of this Regulation respect the principle of proportionality, having regard in particular to the diversity in size and scale of operations and to the range of activities of institutions... Member States should ensure that the requirements laid down in this Regulation apply in a manner proportionate to the nature, scale and complexity of the risks associated with an institution's business model and activities"*².
18. The European Banking Authority (EBA) Banking Stakeholder Group in a recent report on proportionality³ adds: *"[...] the dangers of a one-size-fits-all approach are clear: such an approach may lead to unintended consequences in that, for instance, the costs of regulation fall particularly heavily on small banks (because of the fixed cost element of the necessary compliance infrastructure) and yet mostly these institutions pose less systemic risk."* The EMF-ECBC agrees with this view. Proportionality should, in fact, be preserved and differentiation, i.e. granularity should be maintained.
19. In fact, new capital floors, based on the standardised approach, will impact high quality IRB portfolios disproportionately. For a number of financial institutions, this kind of new floors is likely to become the binding capital requirement, even calibrated on 60%.
20. For all these reasons, the EMF-ECBC, in general, does not favour the application of capital floors.
21. In January 2016 the Group of Governors and Heads of Supervision (GHOS) indicated that the Basel's Committee will not focus on increasing (at least significantly) overall capital requirements. Based on

² [Regulation \(EU\) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation \(EU\) No 648/2012](#), recital 46

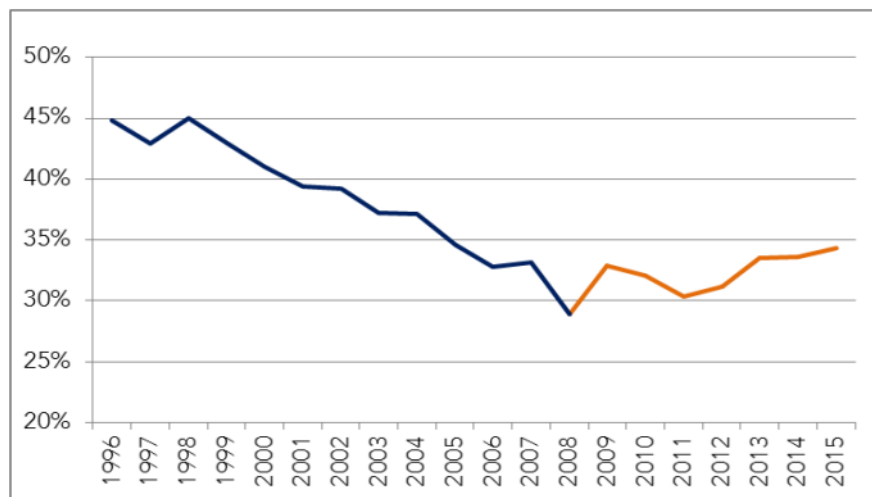
³ EBA Banking Stakeholders Group, ["Proportionality in Bank Regulation"](#)

the most recent Committee's publications (final standards for Market Risk and consultations for operational and credit risk, including capital floors) the capital requirements for a number of European institutions increase very significantly. A substantial change of the current proposals is required to realise this GHOS goal.⁴

III. Output floors

22. The EMF-ECBC is of the opinion that all the revisions to the capital framework (credit risk, market risk, operational risk) should suffice, and more, to achieve the Basel Committee's purposes and therefore there should be no need for output floors.
23. Since 2007 the capital quality and levels (CET1%) have increased significantly around the globe. In a report published in April 2016⁵, the Institute of International Finance (IIF) indicates that it is often claimed that banks' shrunk their own risk-weights by using internal models (and that models are therefore just a way to reduce capital requirements). However, the post-crisis data reveal a different picture: the risk weights of the European GSIBs increased as from 2008, see chart below from the report. Additionally, supervision has been strengthened (in Europe the supervision has been centralised), including increasing the number of on-site visits. The internal models have been thoroughly scrutinised. Stress tests and Asset Quality Assessments have helped to improve the quality of data, risk management, reporting and modelling. As a back-stop, the leverage ratio will be introduced.

Average Risk Weighted Assets, European G-SIBs, 1996-2015
Basel I in blue Basel II in orange



Source: IIF

24. This long list of revisions has strengthened the capital levels, also for A-IRB portfolios. Output floors are not needed from a capitalisation point of view. They will increasingly blur the link between risks and capital, weakening the Basel standards. Output floors have the potential to trigger sub-optimal

⁴ GHOS, Press release: "[Revised market risk framework and work programme for Basel Committee is endorsed by its governing body](#)", January 2016

⁵ IIF, "[Basel's Evolution: a retrospective](#)", April 2016

portfolios, pricing decisions and the availability of loans, which – at least in the long run – might contribute to grave market distortions. This can have a negative impact on both growth and stability.

25. The effect of this revision will be asymmetrical. Some business models, especially those focussed on low margins and high volumes, will be unevenly affected. For instance, banks with relatively large portfolios of residential mortgages will be particularly impacted and the EMF-ECBC does not see the reason for this business model to be targeted in particular. A thorough consultation and calibration process has not yet been completed and we feel that the effect could be far more disruptive than actually foreseen, especially on those smaller financial institutions or specialised lenders which form the backbone of the European financial system.
26. Capital floors based on the new standardised approach will typically not reflect a bank's risk according to its balance sheet, business model and the markets it operates in. It will present the bank as if its business model is one of a "standardised bank" and as if it operates in different markets than it actually does. The idea that capital requirements based on a standardised model will increase comparability is simply flawed. If there are differences in the actual risk in two portfolios belonging to the same exposure class – which is often the case⁶ – a capital requirement that at least in some way reflects that actual risk will provide for better comparability than a capital requirement that does not capture the risk at all. Risk-based capital requirements, using banks' internal approaches, will thus cater for better comparability between banks for investors who care about the capital adequacy of banks and the risk that the bank will not sustain unexpected losses.
27. In a number of European jurisdictions the actual levels of losses and impairments from mortgage lending, for instance, are in the low end of the global distribution. In some of these jurisdictions, the implied risk weights based on loss experience are in absolute and relative terms very low – also compared to the proposed risk-weight in the revised standardised approach. Consequently, output floors based on the standardised approach (and in some cases even the introduction of parameter floors in the IRB model) would disconnect the link between the risk of these loans and the required capital levels in the market. The pricing of mortgage loans would then be distorted.
28. This would have negative consequences for the overall economy likely cutting growth potential. Furthermore, it could induce the credit institutions affected by disproportionate increases in capital requirements that do not reflect the risk of their current business model to engage in higher risk businesses and relieve their balance sheet of low risk loans. This, we believe, would not be conducive to financial stability.

IV. Scope of use of internal models

29. In A-IRB models, expected losses are periodically compared against provisions and actual losses. Through proper comparison over multiple years potential model under-estimation or over-conservatism are being identified and addressed periodically. These periodical internal model performance studies (loop-back) – including the studies performed by independent Model Validation units and by the supervisors (benchmark studies) – continuously lead to model improvements and keep these internal models fit for their intended use. This process is one of the reasons why A-IRB is perceived to be more reliable than the other credit risk frameworks to properly estimate the risk of a

⁶ See for instance the differences in non-performing residential mortgage loans in Appendix 1. The difference between countries has been significant even in situations of deep economic stress.

portfolio. Therefore – in line with the aforementioned GHOS statement⁷ – the other credit risk frameworks should serve as credible fall-back. This is why the EMF-ECBC believes that care should be taken when overwriting the IRB based risk weights with input floors and output floors or denying the IRB framework for complete exposure classes (or subset thereof).

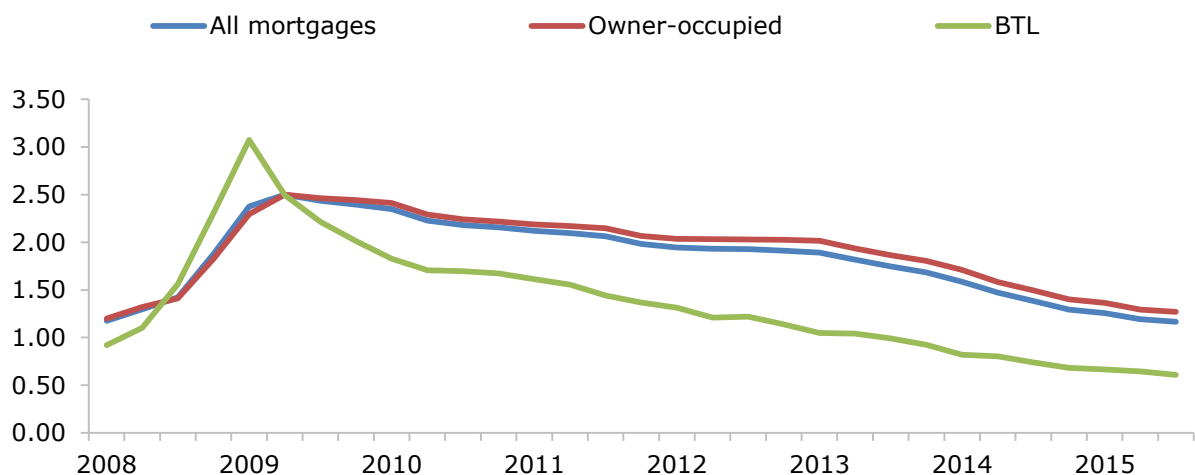
30. Rather than eliminating the possibility of choosing between IRBs, it would be much more appropriate to harmonise internal methods, both A-IRB and Foundation-IRB (F-IRB). The best way to address undue differences, if any, would be a more harmonised PD- and LGD-estimation.
31. As said, the EMF-ECBC insists that banks' internal models are a solid method to properly estimate the risk within portfolios of the bank. If there is a sufficient number of annual observations within a bank portfolio to build adequate internal model, these banks should be allowed to use the A-IRB framework. Besides internal data, pooled data from data consortiums like the Global Credit Data (GCD) consortium could enhance the quality of internal models. Finally, institutions improve the performance of their internal models with non-quantitative information.
32. We strongly believe that unintended risk weight variation can be best reduced by addressing its roots. That is, the Basel Standards provides a high level framework, which then needs to be implemented in local legislation. Implementation has not been fully harmonised. Also the local supervisors might have had different degrees of flexibility, which led to additional unintended risk weight variation. Lastly, institutions will have made different modelling choices that contributed to the unintended risk weight variation.
33. In case of short time series, banks can still rely on other data about portfolios and perform a deep-dive analysis which has proved to be very informative. As such, the lack of historical information is more than compensated by a variety of figures which enable an overall assessment. Hence we would propose that the regulator defines more stringent modelling methodological standards and stress the margins of prudence without eliminating them at all.
34. Therefore, for all portfolios, for all Basel exposure classes, granting permission to use A-IRB models for calculating minimum capital requirements should in our view be based on clear minimum requirements, including the number of annual observations and the quality of data.
35. Regarding the proposal to restrict the use of A-IRB for certain corporate exposures the EMF-ECBC believes that a gradual approach is warranted. Before restricting the use of the A-IRB, adjustments to its framework (parameter estimation practices) should be implemented and evaluated. Also, the cliff effects, mentioned by the Committee, are already a strong argument for not going forward with the proposal.
36. Furthermore, the rationale for the suggested limits between A-IRB and F-IRB is unclear. In fact, the sheer volume of assets does not necessarily tell much about the risk level of those assets. Rather, it is the kind of business the company operates in that determines the risk level in the company.

IV. Specialised Lending

⁷ GHOS, Press release: "[Revised market risk framework and work programme for Basel Committee is endorsed by its governing body](#)", January 2016

37. We are concerned by the implication that Income Producing Real Estate and Buy-to-Let (BTL) assets should no longer be measured under the IRB approach.
38. The concept of specialised lending should not include homogenous and common residential or commercial real estate exposures where abundant and reliable data is available, even if they share some of the features with specialised lending. The specialised lending approach for income producing real estate should only be applied when real estate is constructed for more specific income producing purposes where tailor-made lending conditions, including control features, are the norm.
39. Whilst the characteristics of BTL assets are undoubtedly different to those of owner-occupied lending, we do not believe the risk weights under the revised standardised approach are appropriate for assets which are secured on residential real estate. The consultation paper does not make clear why the Basel Committee believes it appropriate to make such a significant change to the risk weights applied to this type of lending, to a level which does not appear to be commensurate with the risk attached to these assets.
40. A material increase in the level of capital required for BTL assets will imply to investors that they are more risky than residential mortgage lending, in addition to moving away from the Committee's intention to avoid significant increases to overall capital requirements. Industry-wide historical arrears rates data show risks within BTL markets to be broadly aligned to owner-occupied mortgages, see for instance the UK here below. Whilst during the recent financial crisis, BTL arrears rates peaked at c. 3%, action has subsequently been taken by banks and regulators to strengthen the underwriting controls surrounding new BTL mortgage loans.

UK arrears data by line from 2008 to 2016



Source: UK Council of Mortgage Lenders

41. Across the EU, a number of macroprudential policies are deployed to lean against the wind in BTL markets. For example, the PRA in the UK is consulting on minimum market stress rates and more detailed underwriting checks for borrowers with larger portfolios. If combined with national macroprudential policies, the changes being proposed here could have a significant and material impact upon BTL markets within individual countries. In addition, the increases to the level of capital required are likely to lead to higher pricing and reduced availability of BTL mortgages.

42. In order to limit the potentially damaging impact that these proposals could have upon the BTL markets within individual jurisdictions, the Basel Committee should allow national discretion, to permit competent authorities to allow BTL assets to continue to use the IRB approach. This is the approach currently taken within Europe under the Capital Requirements Regulation, and we believe it is appropriate for this discretion to remain in place.

V. Parameter Floors

43. The Basel Committee aims to reduce the unintended risk weight variation, a goal we fully support. Nevertheless, we are convinced that there are better ways to address unintended risk weight variation than introducing input floors for all IRB portfolios. We kindly refer to the section "Scope of Internal Models" in which we suggest to address the root causes of unintended risk weight variation: the input of models, rather than harmonising model values (PD, LGD and EAD) by overwriting risk sensitive information.
44. Input floors that do not take into account the level of model accuracy will weaken the relation between actual risk and risk weights. For the stability of the financial system it is essential that the capital requirements are kept in line – to the extent possible – with the actual risks in order to support transaction and portfolio decisions to the extent possible. This will reduce situations in which clients will receive either too few or too much credit or pay too much or too little interest vis-à-vis the actual risks. These kinds of market distortions could lead to undesired volatility in the economy.
45. This said, the EMF-ECBC feels that the proposals for exposure-level input floors on the model parameters are preferable also for those exposures that the Basel Committee proposes to exclude from IRB-methods and also for those exposures for which the use of A-IRB are limited.
46. In addition, it is clear that parameter floors are very sensitive to differences across regions/jurisdictions in definitions of subcomponents for the relevant parameter. For instance, there are substantial differences in the way "default" is defined across jurisdictions. This is why, preferably, the alignment of definitions and supervisory practices should be prioritised instead of introducing parameter floors. In theory, input floors should only floor incorrect (too low) model values, they should not floor low PD and LGD values that accurately reflect the actual risks. Input floors that do not take into account the level of accuracy of the internal models could increase the unintended risk weight variation, especially where input floors will force banks to use the same risk weights for different risk profiles. Overwriting accurate risk-sensitive information will reduce comparability and misinform the investors
47. This said, if the parameters floors were to be introduced, they should bind at a portfolio level rather than at an individual exposure level. Floors at portfolio level would achieve the objective of avoiding perceived under estimation of risks for certain exposures types as a source of undue variation between banks but at the same time preserve some risk differentiation for low risk exposures within the portfolio. Compared to an exposure level floor, this would improve incentives for banks to retain and manage low risk exposures in their portfolios. However, parameter floors will in any case be problematic for lenders.
48. As far as low default portfolios are concerned, the shortcomings of internal models due to the absence of a large number of observations could be addressed in a more constructive manner than by the introduction of floors. Higher margins of conservatism on the raw model outcomes could be imposed, based on objective data availability and data quality measures, such as the number of default

observations and loss observations. This would encourage banks to invest in data quality improvement and data pooling of credit loss data for low default portfolios. Moreover, in the current proposal, PD floors are basically envisaged for retail and corporates (except for the largest firms). Since default events for these exposures are numerous, the use of floors seems both unnecessary and unduly penalising.

49. In case floors are envisaged, in order to reflect the level of accuracy of the internal models, we suggest including the performance of the model in the calibration process of the input floors. For PD models, the performance of the models should be assessed by comparing the predicted PDs to the observed default frequencies. For LGD models, the predicted LGD values should be compared to the actual losses. If the performance is sound (no underestimation of risks) the input floors should not be activated to the model. The National Competent Authority (on the basis of objective criteria agreed upon the Basel Committee) should be in charge of activating input floors. This action should be triggered by evidences that the model in question is performing below a certain level of accuracy.
50. Input floors that are activated and calibrated based on the level of accuracy of the internal model could address potential underestimation of risk for both lower risk portfolios as also for higher risk portfolios. The current Basel Committee proposal is only applicable to portfolios with lower PD and LGD values, which often is an accurate reflection of lower risk assets. Therefore, the current Basel Committee proposal often does not address underestimation of risk. It simply increases the risk weights. This, in itself, would penalise lower risk portfolios and creates an un-level playing field.

VI. Parameter estimation practices and fixed supervisory parameters

F-IRB

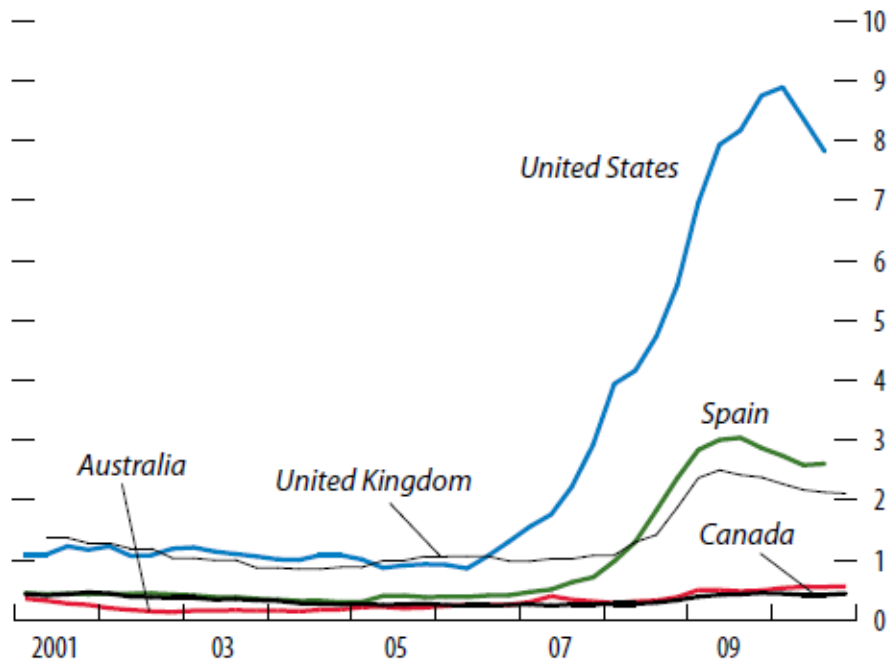
51. In general, the EMF-ECBC welcome the modifications proposed to the method for calculating LGD under the F-IRB approach. However, the EMF-ECBC believes the method could be made more risk sensitive by adjusting the proposed haircuts and LGDs parameters. More specifically, as above, residential real estate should be subject to lower haircuts than commercial real estate.
52. Hence, lower haircuts and LGDs-values should be introduced for residential real estate. The lower riskiness of residential real estate compared to commercial real estate is recognised in the current regulatory framework and in the proposed new standardised method and should also be reflected in the F-IRB approach to maintain some degree of risk sensitivity.

VII. State guaranteed mortgage structures

53. In the Netherlands approximately 25% of all residential mortgages benefit from a National Guarantee Scheme (Nationale Hypotheek Garantie / NHG), in which the counter guarantee from the Dutch Central Government reduces the LGD values considerably. Other countries may have other guarantee arrangements. In the current proposal no specific mention was made with respect to governmental guarantees. Given this assumption, the proposed 10% floor will significantly increase the capital requirements for these mortgages. Next to the government guarantee schemes, there are various commercial insurance in the Netherlands, where the risks are also reduced considerably. We kindly ask the BCBS to maintain the current regulatory treatment for these kinds of structures.

Appendix 1. Non-performing residential mortgage loans in various jurisdictions, IMF Global Financial Stability Report, April 2011

Non-performing Residential Mortgage Loans (in % of the total residential mortgage loans outstanding)



Source: Federal Reserve Bank of New York; Reserve Bank of Australia; Bank of Spain; UK Council of Mortgage Lenders; Lea (2010b).

Note: Nonperforming loans that are more than 90 days in arrears. For Australia, Canada and the US, banks only.