

27th of March 2015

Final EMF Response to BCBS Consultation on Revisions to the Standardised Approach to Credit Risk

General Comments

As a very first remark, the European Mortgage Federation¹ (EMF) would like to underline that it does not perceive any urgent need for a revision of the standardised approach for credit risk. Most banks that use the standardised approach are small or medium-sized and focus on retail lending. For these banks, the proposal will add significant complexity and compliance costs, without necessarily strengthening the measurement and control of risk.

The EMF would also like to emphasise that it is not appropriate to define a detailed standardised approach for credit risk that is globally applicable. The conditions of the banks addressed are too different for a fully harmonised, *'one size fits all'* approach to work. It is vital that the Basel Committee on Banking Supervision's (BCBS) work in this area focuses on determining an appropriate high-level framework which can then be calibrated locally to take account of differences in legal and regulatory environments, accounting rules, the level of welfare support from the state, the variability of real estate prices, etc. The EMF believes that local calibration should not be considered tantamount to national discretion, but rather to ensuring the efficient and smooth functioning of markets according to their characteristics.

The BCBS states in its introduction that *"increasing overall capital requirements under the standardised approach for credit risk is not an objective"*. However, for a number of banks under the standardised approach, including the specialised mortgage bank model which is widespread in Europe, the BCBS's proposals would result in a significant upward change in required capital levels (see examples provided in answer to Q11). Moreover, important differences already exist in required levels of capital between banks under the standardised and IRB approaches, and the proposal would only serve to increase those differences (subject to the definition of the floor).

The EMF will respond separately to the BCBS Consultation on the design of a capital floor framework, but the EMF would like to take this opportunity to underline that the present consultation and the capital floor consultation should be seen very much together, if that is not already the case, because banks using internal model-based approaches will be impacted by the proposal for a capital floor based on the new standardised approaches, especially where – as appears to be the case – the new standardised risk weights impose a higher starting point.

Regarding residential mortgage loans, and setting aside subprime lending in the US and specific pockets in the EU, in our view, there is not one EU jurisdiction where the financial crisis has exposed the existing calibration as not being prudent (page 15 of the consultation). Even in Member States which experienced an extensive real estate crisis, retail residential mortgage loans have not generated high levels of losses. The EMF would therefore welcome clarification from the BCBS on the justification for/evidence necessitating increased risks weights in the EU for residential and commercial real estate

¹Established 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 €6.7 trillion at the end of 2013. As of February 2015, the EMF has 18 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. The EMF-ECBC is registered in the EU Transparency Register under ID Number 24967486965-09.

exposures in particular. In fact, the EMF would like to take this opportunity to emphasise the fundamental risk mitigating effect of the mortgage collateral, which distinguishes mortgage lending from unsecured retail/consumer lending. With these considerations in mind, the EMF questions the appropriateness of amending an international calibration in order to solve a localised issue.

The EMF would like to take this opportunity to express its view that as a general rule, risk weights attributed to performing loans across the different asset classes should not be higher than the risk weight attributed to non-performing loans, irrespective of the LTV.

While the EMF acknowledges the reasons why the Committee would want to focus on guarantees, some of the operational requirements (article 128(a) in particular) are too detailed and should be left to the local regulator to assess. Taking the example of French public sector guarantees, which are very prevalent in the social housing and associative sectors for instance, the requirement for the bank to *“have the right to receive payments from the guarantor without first having to take legal action”* would mean they would not be recognised. This would be in direct contradiction with the protection they have been shown to provide in case of financial difficulties. Not all guarantees will be first demand guarantees and the fact that they are first demand or not is not the best way to assess their usefulness (e.g. sharp decline in the monoline guarantee business since the financial crisis).

Exposures to banks

The EMF is extremely concerned that, according to the proposed treatment of bank exposures in the consultation, covered bonds would no longer receive a preferential 10% risk weighting under the standardised approach, but would instead receive the same risk weighting as other exposures to banks, starting at 30%. To recall, covered bonds are dual recourse debt instruments issued by credit institutions and secured by a cover pool of financial assets, typically composed of housing loans or public-sector debt.

The covered bond asset class plays a key role in guaranteeing financial stability, thanks to key safety features, including a strict legal and supervisory framework, asset segregation and a cover pool which is actively managed in order to maintain the quality of the collateral. They have played a pivotal role in bank wholesale funding during the recent financial turmoil as one of the only asset classes able to restore investor confidence and ensure access to debt capital markets for European issuers.

The covered bond industry is constantly working to maintain the quality of the asset class and strengthen secondary market activity and, based on an intense and constructive dialogue between the issuer and investor communities, major national and European authorities and European law firms, recently committed itself to a major harmonisation process, by way of the Covered Bond Label². This has triggered a steady convergence of cover pool transparency practices at national level, based on minimum European standards, and a continuous process of amending covered bond legislation. This exercise of convergence has ring-fenced the core key qualitative features and market best practices and ensured a solid investor base.

With over EUR 2.6 trillion outstanding at the end of 2013, covered bonds continue, now more than ever, to play a central role in banks' funding strategies. The EUR 429 billion issuance and arrival of 10 new issuers during 2013 for a total of more than 300 issuers in more than 25 Member States evidence the ability of the asset class to provide essential access to long-term capital market funding, even during volatile market conditions, notably thanks to a stable investor base.

²<https://coveredbondlabel.com>

With all of these considerations in mind, the EMF urges the BCBS to reconsider the specific case of covered bonds and their treatment under the proposed revisions to the standardised approach, and to maintain the current 10% risk weighting.

Q2: Do respondents believe the net NPA ratio is an effective measure for distinguishing a bank exposure's credit risk? What alternative asset quality measure, if any, should be considered by the committee?

As it stands, the net NPA ratio does not give credit to guarantees received, which may well reduce the apparent level of provisioning. We believe for that reason that this ratio should be computed post LGD reduction measures used by the bank.

Exposures to corporates

Q8: Do respondents agree that introducing the specialized lending category enhances the risk sensitivity of the standardized approach and its alignment with IRB?

In the first instance, we believe that the proposed specialised lending category mixes together exposures pertaining to very different categories of risk. For example, an oil exploration project in an emerging market would be treated the same as a fully rented prime office property in London's central business district. We believe that income producing real estate provides for much more predictable cash flows than most project or object finance transactions and as such is disadvantaged in the proposed grouping.

Also, while structuring real estate transactions, banks often require that the property being financed is isolated within an SPV so that the cash flows available to repay the loans are more predictable. Segregation allows the lender to take security over a valuable asset and its related cash flows, and to ring fence the structure from other creditors. For those reasons, the lender's position is significantly improved as compared to an unsecured corporate loan situation, and as a result we disagree strongly with the proposal that a higher risk weight would be warranted.

Looking at certain of the specific categories of "specialised lending" as determined by the BCBS:

- **Income-producing real estate (IPRE):** The consultation is ambiguous over the treatment of Buy-to-let lending (BTL). Larger "professional" BTL would appear to be captured under the "income-producing real estate category" of specialised lending (i.e. loans *"where the prospects for repayment and recovery on the exposure depend primarily on cash flows generated by the asset"*) and thereby attract a considerably higher risk weight (120%) than is currently the case. Smaller BTL operators (individuals) would appear to fall under the "other retail" (paragraph 39) with a potential risk weight of 100%. This is inconsistent and means that loans back by similar asset portfolios are treated differently. The EMF does not agree that BTL on residential properties represents a significantly more risky asset class and therefore cannot agree with the proposed changes in risk weight. The EMF would like to underline that BTL receives the same treatment as owner occupied property under the Capital Requirements Regulation (CRR).

Although the consultation paper does not specifically mention lending to housing associations, without further clarification, it would appear that lending to social housing associations would also be classified as either specialist or corporate lending and therefore attract a higher risk weight. The EMF considers that this is an unintended consequence of the consultation paper and, given the

default/loan loss characteristics of the sector, either an exemption or an alternative risk weight should be employed for this asset class.

- **Land Acquisition, Development & Construction (ADC) Lending:** The proposed risk weight of 150% jeopardises the ability of the entire industry to access funding. Needless to say, this industry is significant in terms of employment and is a major driver of growth. 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. A suggestion would therefore be to allow national discretion in the case of required completion guarantees.

The EMF believes that a greater element of granularity between asset classes should be introduced within the specialised lending criteria to reflect the characteristics of the markets in question. Concretely, the EMF believes that the asset classes highlighted above should be risk weighted according to a different calibration:

- For IPRE, the logical risk drivers would be LTV, similar to what the Committee is proposing for retail mortgages (the LTV is also proposed for commercial mortgages not qualifying as specialised lending), and potentially Interest Coverage Ratio (ICR).
- For ADC lending, the following ratios could be used: LTV and potentially “pre-contracted revenue percentage”.

Retail Portfolio

Q9: Can respondents suggest, and provide evidence on, how to increase the risk sensitivity of the regulatory retail exposures treatment, either by differentiating certain product subcategories for which a specific risk weight may be appropriate; or by suggesting simple risk drivers that could be used to assess the risk of all retail exposures?

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 Italy³).

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.

In the case of Italy, these guarantees are:

- direct assignment of one-fifth of the pension or salary to cover payment of the loan instalments;
- 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);
- transfer of the effects of the assignment of salary to the pension when the borrower retires;

³In Italy, loans repaid by the assignment of salary or pension are ruled by Presidential Decree 180/50 (and subsequent amendments and additions), by the related enabling regulatory Presidential Decree 895/50, and by various instructions from the Ministry of the Economy and Finance and the Bank of Italy on the proper implementation of the regulations.

- (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.

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 survey⁴ carried out by the Italian Banking Association (ABI) that, with reference to pensioners and public employees, showed that:

- the probability of default (PD) within 12 months is 3.0%
- there is 32.6% return to performing status within one year
- the effective loss rate (weighted-average LGD rate) is 5.8%⁵
- the expected loss (EL) is 0.16%.

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%).

Exposures secured by residential real estate

As a preliminary comment on this asset class, it is common practice in France for home loans to benefit from a guarantee from a financial institution ("prêt cautionné") rather than a mortgage ("hypothèque") as such. Both types of home loans should be considered as being captured under "Exposures secured by residential real estate".

Q10: Do respondents agree that LTV and/or DSC ratios (as defined in Annex 1 paragraphs 40 and 41) have sufficient predictive power of loan default and/or loss incurred for exposures secured on real estate?

LTV:

The LTV is a simple indicator and its use is widespread in all EU Member States. Therefore, the EMF acknowledges its use as a determinant of the risk weight. Having said this, in our view, the LTV buckets proposed are not appropriate because they are overly restrictive (see response to question 11).

At this point, the EMF would also like to underline that the real personal contribution is potentially a better predictor of loan debt and/or loss incurred than the LTV, because it objectively reflects the commitment of the client to the financial operation, while the LTV may be influenced by fiscal factors, with high taxes and expenses associated with real estate purchase in some Member States.

Linked to this, the EMF would furthermore like to point out that LTV can be a 'blunt tool', which masks the true nature of the borrower's financial circumstances. For example, in the Netherlands, LTVs can typically be in excess of 90% and even 100%, driven largely by the incentives provided by tax

⁴Eleven out of twelve intermediaries participated in the survey described below, providing over 80% coverage of 2013 loans guaranteed by the assignment of one-fifth of salary or pension.

⁵The weighted-average LGD rate was provided by a sub-sample of 7 respondents.

deductibility possibilities. However, in the Netherlands, lending is very often matched by high levels of personal savings and private pension reserves, which off-set the potential risk associated with the high LTVs. For mortgage linked savings and products a reduction of the nominal LTV could be logically applied, and therefore reduce accordingly the risk weighting. Moreover the Dutch market is known for its very low arrears and defaults.

DSC:

The EMF does not agree with the DSC as a determinant of capital consumption in loans secured by residential property and believes that it should be eliminated for the following reasons:

- Defining comparable DSC across jurisdictions is challenging: DSC ratios are sensitive to different fiscal frameworks and social benefits
- The BCBS itself recognises that a 35% DSC in high income groups is not the same as for low income borrowers. An individual with a high income may well be able to afford a higher DSC, without their propensity to default increasing.
- There could be legal obstacles which impact on a lender's ability to reassess the affordability of borrowers on an ongoing basis.
- DSC is typically used in the credit application approval process of banks as an indication of the borrower's capacity to repay. However, risk management practices do not indicate that riskiness is a linear function of a DSC ratio. It is only used as a backstop.
- The DSC ratio at origination does not reflect the risk of the exposure in the long term.
- The DSC includes amortisations. The fact that the indicator increases the more the consumer amortises is counter-intuitive.

Q11: Do respondents have views about the measurement of the LTV and DSC ratios (in particular, as regards keeping the value of the property constant as measured at origination in the calculation of the LTV ratio; and not updating the DSC ratio over time.)

Regarding the LTV, there are however a number of factors which need to be taken into account:

- i. The requirement for banks not to tranche their exposures across different LTV buckets would have several negative consequences:

- a) Cliff effects would be created around the LTV thresholds as shown below:

LTV	79 %	80 %	89 %	90 %	99 %	100 %
Existing RW	35 %	35 %	39 %	39 %	43 %	43 %
Proposed RW*	40 %	50 %	50 %	60 %	60 %	80 %

*assuming DSC<35%

- b) A significant increase of risk weights up to 70% for LTVs above 80% (and with DSC>35%), where most of the market and certainly the market for first time buyers lies. This contradicts the stated objective of the Committee of not increasing overall capital levels. Furthermore, experience from markets which have undergone a pronounced economic and housing crisis resulting in an increase in defaults, for example the Spanish mortgage market, shows that loans with an LTV of between 60% and 80% (including the upper limit) are not the loans which are producing the "arrears" in the portfolio. On the contrary, the higher risks arise in those loans with a combination of extremely high LTV ratios (>90%) and high DSC ratios, or

in those with specific “debtor” characteristics (e.g., type of employment, family composition or nationality).

- c) A higher risk weight for exposures secured on residential real estate with LTVs above 90% and with DSC>35% (80-100%) than unsecured retail exposures (75%). This is in our view a serious inconsistency which must be addressed.
- d) Regulatory arbitrage opportunities would be created: 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:

		DSC ≤ 35%							
		LTV = 30%	LTV = 40%	LTV = 50%	LTV = 60%	LTV = 70%	LTV = 80%	LTV = 90%	LTV = 100%
RW	One loan	25%	30%	30%	40%	40%	50%	60%	80%
	Combination of loans	0/40	25%	25%	25%	25%	25%	25%	25%
		40/60		30%	30%	30%	30%	30%	30%
		60/80			40%	40%	40%	40%	40%
		80/90				50%	50%	50%	50%
		90/100						60%	60%
	overall	25%	27%	27%	30%	30%	32%	32%	35%
RW gain when several loans vs. one loan		0%	3%	3%	10%	10%	18%	28%	45%

- ii. According to the proposal, the BCBS is considering requiring that the original value of the property and the original DSC, 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. This is particularly the case for interest only mortgages, where a risk weight of 70% would be required during the entire duration of a loan with an LTV of 80% and a DSC greater than 35%, according to the approach outlined above. Moreover, 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. With these considerations in mind, the EMF believes that the basic principle should be as follows: the numerator of the equation would be updated as proposed by the BCBS, there should be no obligation to update the denominator, i.e. the value of the property, but, in order to comply with risk sensitivity requirements, a degree of flexibility should be introduced into 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).
- iii. The consultation assumes in the requirements regarding the calculation of the LTV 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 market practice in France.
- iv. The requirement for the property to be fully completed is not clear, given the already existing protective environments available in EU Member States, for example in France under VEFA (vente en état futur d'achèvement) or VIR (vente d'immeubles à rénover), whereby a bank completion guarantee for the benefit of the acquirer/borrower is required from the outset (same comment as Q8).

With all of these considerations in mind, the EMF would like to insist that if the proposal for more granularity is maintained, consideration should be given to **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. One possible alternative approach is as follows:

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

Q12: Do respondents have views on whether the use of a fixed threshold for the DSC ratio is an appropriate way for differentiating risks and ensuring comparability across jurisdictions? If not, what reasonably simple alternatives or modifications would respondents propose while maintaining consistent outcomes?

As suggested above (see Q10), defining comparable DSC across jurisdictions is challenging: DSC ratios are sensitive to different legal and fiscal frameworks and social benefits. Also, a 35% DSC in high income groups is not the same as for low income borrowers.

Q13: Do respondents propose any alternative/additional risk drivers for the Committee's consideration in order to improve the risk sensitivity in this approach without unduly increasing complexity?

Additional guarantees change substantially the risk profile of mortgage loans and could be considered without adding too much complication. In such cases, it is important that the LGD reduction effects of such guarantees be taken into account. For instance:

- Parental guarantees are commonplace and could enhance the value of the guarantee.
- Some form of unemployment insurance policies.
- Private insurance schemes such as the *Crédit Logement* in France.
- Public guarantees such as the *Nationale Hypotheek Garantie* in the Netherlands.

Exposures secured by commercial real estate

Q14: Which of the two options above is viewed as the most suitable for determining the risk-weight treatment for exposures secured on commercial real estate?

As suggested in the EMF's general remarks section, both options proposed are more penalising than the current risk weight of 50% for LTVs <60% and yet there is no data provided to explain this proposed increase. Furthermore, both proposals reduce the importance of this type of collateral which is especially used to secure SME exposures. These options, together with the new definition of default, will contribute to the creation of credit crunch phenomena.

Looking at the options individually:

- Option A does not reflect the significantly superior position of a lender secured by a first mortgage versus an unsecured lender except in cases covered by the national discretion.
- Option B is potentially sounder in principle but, as indicated, would represent a significant increase from current risk weight levels and as such, should include the national discretion that is being suggested in Option A. A further consideration here, as above, is that a secured exposure could have a higher risk weight than an unsecured exposure, which is a serious inconsistency. Additionally, similar concerns as raised in the response to Q11 regarding the proposed absence of tranching (leading to cliff effects and to regulatory arbitrage opportunities) are relevant here, as are reservations about the differentiation between completed and non-completed properties in cases where a completion guarantee is in place.

Q15: What other options might prudently increase the risk sensitivity of the commercial real estate treatment without unduly increasing complexity?

No answer provided.
