From:	**The European Mortgage Federation**
Issue:	Position Paper on the Basel Committee's Third Consultative Paper of the New Capital Accord
To:	**Basel Committee on Banking Supervision** Mr Jaime Caruana, Chairman Mr Nicholas LePan, Vice-Chairman Ms. Daniele Nouy, Secretary General Basel Committee Secretariat
Copied to:	**European Commission** Gerald Dillenburg, DG Markt Gerry Cross, DG Markt **European Mortgage Federation** EMF Capital Adequacy Working Party National coordinators for EMF member countries EMF extranet
Summary:	Please find herewith the European Mortgage Federation's Position Paper Responding to the Basel Committees Third Consultative Paper on the New Capital Accord The Federation's outstanding concerns relate to the need for a wider acceptance of partial use of IRB approach and a reconsideration of 10% LGD floor on residential mortgages. We also have concerns that some proposals will decrease the attractiveness of securitisation as a source of funding. We would be happy to discuss any questions you may have regarding our response.

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Dear

The European Mortgage Federation[1] welcomes the opportunity to comment on the Basel Committee's Consultation Paper No.3. The Federation's comments are set out below.

PILLAR ONE – CREDIT RISK

Revised Standardised Approach

Residential Mortgage Lending (paragraphs 45-46)

The Federation welcomes the new 35% risk weight for lending fully secured by mortgages on residential property that is or will be occupied by the borrower (or that is rented) even though this weighting is dependent on strict valuation rules and the existence of substantial margin of additional security over the amount of the loan.

In a jurisdiction where the national supervisor applies a higher risk weight to higher loan-to-value lending to national lenders, the same risk weight should be applied to lending by non-national lenders in that jurisdiction. This will ensure a level playing field.

In addition, the Committee should specify that the part of the residential mortgage loan not meeting the requirements for the favourable 35% weighting should be weighted at a figure no higher than 75% - the next possible weight and not 100%. This will ensure consistency with other retail business (mainly unsecured) which is weighted at 75%.

Internal Rating Based Approach

With respect to the definition of corporate exposures the Federation considers that the five sub classes of specialised lending (SL) set out in paragraph 187 do not fully encompass the entirety of corporate exposures. A sub-heading above paragraph 187 could be inserted making it clear that the 5 sub-classes do not represent an exhaustive list of corporate exposures.

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[1] Established in 1967, the European Mortgage Federation (www.hypo.org) is a regional association which groups over 20 national trade associations from all EU member states and increasingly the accession countries. It represents lenders who grant more than 75% of residential and non-residential mortgage loans in Europe and provides data and information on European mortgage markets.

The Federation urges the Committee to recognise that banks meeting the requirements for the estimation of probability of default will be able to use the foundation approach to corporate exposures for all SL classes except high volatility commercial real estate (HVCRE) where a specific risk weight curve applies.

The Federation believes that the HVCRE definition does not deliver clear and consistent criteria about the different property types falling under this category. The risk weights for SL contained in paragraphs 244 and 249 are too high and should be lowered.

Definition of retail exposures (paragraphs 199-200)
Residential mortgage loans are defined in paragraph 199 as eligible for retail treatment 'as long as the credit is extended to an individual that is an owner occupier', subject to supervisor flexibility with respect to a building with a few rental units as well. This definition is inconsistent with that elsewhere in Basel 2, restrictive and potentially very subjective. The phrase ‘containing only a few rental units’ should be amended. Alternatively, greater national discretion should be allowed.

Borrowers in a number of European countries typically raise a mortgage to buy a property to let it out with repayment of interest and debt flowing from the rent. Lenders may cover the additional risks by lower loan-to-value ratios, tougher underwriting criteria, exposure limits to individuals and more detailed valuations. On the basis of the definition applied, such loans would typically be treated as corporate except where the borrower owned a block and let out all the apartments except the one occupied by the borrower her/himself.

The current definition is both unclear and unnecessarily prescriptive. The Federation considers that the definition should read as follows:

Residential real estate which is or will be occupied or let by the owner and/or the borrower.

Foundation and advanced approaches (paragraphs 213-221 and paragraph 472)
With respect to operational requirements for eligible CRE/RRE the term of 'current fair value' should be replaced by 'market value' and an insurance against deterioration seems to be disproportionate

Adoption of the IRB approach across all asset classes (paragraphs 225-231)
The new Accord only grants a permanent partial use for non-material exposures. The Federation requests a permanent partial use across business units in the same banking group and across well separated asset classes in order to reflect the specific structure of the European banking industry.

Paragraph 228 provides for partial use of the IRB approach by exempting “exposures in non-significant business units as well as asset classes (or sub-classes in the case of retail) that are immaterial in terms of size and perceived risk profile”. This is a useful provision in so far is it goes. However, the Committee should seriously consider the additional partial use provision suggested in the European Commission’s November 2002 Working Document (draft Article 50(2)) which would

allow institutions using the IRB approach for other asset classes to apply the standardised approach permanently for exposures to institutions and sovereign exposures, subject to approval of the competent authorities.

The Federation notes the text in the consultation paper on partial use with respect to operational risk (paragraph 641). This could usefully be applied to credit risk. The provisions with respect to phased roll-outs in the Accord are insufficient.

Transition arrangements (paragraphs 232-238)
The Federation is also opposed to the 10% LGD-floor for retail residential mortgages in the IRB approach. These provisions run contrary to the underlying principle of risk sensitivity in the whole Accord and considerably reduce the incentive for banks to use the more advanced risk measurement techniques. The Federation is unaware of any justification for what is proposed. The low risk profile of residential mortgage lending across Europe must be fully reflected in actual LGDs and not in floors limiting reductions in capital requirements.

Residential Mortgage Exposures (paragraph 298)
The Federation remains unaware of the evidence in favour of a higher asset correlation (15% paragraph 298) for residential mortgage loans compared to other retail loans. If a mortgage and a consumer loan are granted to the same borrower, there is no difference in the borrower's behaviour justifying a higher asset correlation for the mortgage loan. The same borrower is still facing the claims generated by both the consumer and mortgage loans. Therefore, the Federation requests an equal treatment of mortgages with other retail loans, i.e. the application of the 'other retail' asset correlation figure to residential mortgages.

Minimum Requirements for IRB Approaches (Part H)
In paragraphs 363 and 364 on standards for retail exposures, the consultation paper sets out views as to how retail loan books might be segmented to secure a meaningful differentiation of risk. While accepting this is necessary there is a danger lenders with relatively undifferentiated high quality loan books are forced to undertake unnecessary differentiation into segments which for a variety of reasons cannot be meaningfully populated. In paragraph 371 reference is made to the fact that a single pool must not include an undue concentration of the bank’s total retail exposure. This paragraph and the minimum segmentation requirements set out below might then be used against such lenders in terms of them qualifying for IRB status. In paragraph 364 it is suggested that banks, at a minimum, should consider borrower risk (defined as type, age and occupation), transaction risk (product type, LTV, age of loan) and delinquency (delinquent loans/performing loans). The Federation would argue that this segmentation process should be constrained and potentially be subject to the size and quality of the loan book. Given there will be European lenders for whom mortgages are most of their retail exposure and the quality of their books is such that a complex segmentation is neither possible nor necessary this requirement needs qualifying.

Furthermore, in paragraph 389 lenders will be required to review the loss and delinquency status of each pool annually and to look at a sample of individual borrowers in each pool. The effort required to do this will be magnified by the number of pools, (assuming the application of significance

measures). On a range of evidence, mortgages are low risk and this suggests that there could reasonably be a compromise around the extent of segmentation required.

Securitisation (IV)

The Federation acknowledges the efforts made by the Committee to avoid capital arbitrage through the use of securitisation. Nevertheless there still seems to be higher capital requirements for securitised assets (in total) compared to an on-balance sheet treatment of the same assets (in total). The overall risk weighting should be equal regardless of whether or not the transaction is securitised or not. Securitisation by itself does not increase the credit risk in the banking system.

It is the lower rated securitisation tranches that are particularly penalised under the new proposals in comparison with similarly rated on-balance sheet exposures. For example, corporate exposures rated BB have a 100% on-balance weighting, but the corresponding ABS is weighted at 350%, and for a B rating, the difference is even more marked at 1.250% (deduction from equity) versus 150% for on-balance corporates.

In general, the Federation is concerned that the framework will reduce the attractiveness of securitisation as a funding instrument. The Federation recommends that the Committee reconsiders the risk weightings for securitisation tranches by conducting a further impact study on them.

PILLAR TWO – SUPERVISORY REVIEW PROCESS

The Federation notes that supervisors can require banks to hold capital in excess of the minimum. Section C lists the issues that banks and supervisors should focus on when carrying out the supervisory review process. The Federation believes that the review should not automatically lead to an increase in capital requirements.

PILLAR THREE – MARKET DISCIPLINE

The Federation welcomes what appears to be a reduction in the disclosure requirements under Pillar Three.

QIS 3

The Federation has found it difficult to draw clear conclusions from QIS3 as the range of figures and ratios is broad. Furthermore, the Federation found that the data on mortgage loans could not be easily separated from the data on other assets. Nevertheless the Federation would like to make the following remarks on the study.

- Although the study gives us a view that mortgage risk is lower, it is expected as the study is based upon the responses from the industry. Supervisory authorities clearly do not fully accept this. For instance, the average PD against percentage of defaulted exposures for retail mortgages (Chart 7 page 14 of supplementary information) follows expected logic and points to low risk.

- The paper is confusing because of its constant references to and tables on FIRB retail even though such a category does not exist.

- It would be helpful to get more detailed advice on the make-up of Group 2 banks in each jurisdiction. Mortgage/retail banks seem to come out favourably in the QIS 3 results as suggested by the charts by individual banks which shows percentage change by percentage retail in the appendix i.e. the higher the percentage of retail the greater the percentage reduction in capital requirements.

- Results (the supplementary information on QIS 3) suggest that the new capital charge for operational risk will clearly have a significant impact on mortgage lenders, and will counterbalance much of any likely reduction in capital requirements for credit risk in the new Accord.

Finally, the Federation would like to thank the Basel Committee for the opportunity to comment on the Working Paper.