

27th of March 2015

Final EMF Response to BCBS Consultation on Capital Floors: The Design of a Framework based on Standardised Approaches

The European Mortgage Federation¹ (EMF) is particularly attentive to the combined effect of the Basel Committee on Banking Supervision's (BCBS) proposed revisions to the standardised approach and the design of a capital floors framework, which will be based on the standardised approach. The EMF will comment on the combined effect of the proposals in the general remarks and thereafter on the proposal for a capital floors framework. The EMF's comments on the proposed revisions to the standardised approach are provided separately in response to that consultation.

The EMF would also like to take this opportunity to insist on the importance of a thorough analysis, involving national authorities, of the impact of fundamental regulatory changes of the kind proposed, not only in terms of risk weights, but also on the functioning of established business models. In this respect, the EMF believes that the timeline of the consultation should be extended to permit a broader discussion of the potential merits and shortcomings and impact of the proposal.

General Remarks

1. The EMF does not favour capital floors. The EMF is concerned that capital floors could potentially pose a threat to financial stability if they become the binding capital requirement, because they could incentivise banks to change their current behaviour, for example by replacing low risk assets with high risk assets, with implications for consumers and the wider economy.
2. The EMF is keen for a risk-based approach to be maintained in the future as the basis for determining capital requirements for large banks. Risk based requirements incentivise banks to manage their risk and capital in such a way as to ensure that bank lending is directed to those parts of the economy where it provides most benefit and is priced adequately with respect to the risk of loss.
3. Banks that use the internal ratings-based (IRB) approach have better knowledge and control of their risk, which will ultimately increase the stability of the financial system. The EMF therefore believes that the regulatory framework should give incentives to use internal methods to calculate capital requirements.
4. It is the EMF's assessment that the BCBS' proposal for a capital floors framework based on a revised standardised approach will disproportionately impact high quality IRB portfolios/low risk institutions. For major EU banks, the new floors are likely to become the binding capital requirement as a result of current credit portfolios and a calibration of the floor in line with the current Basel I floor. The continuation of a floor also seems to be much more restrictive for low risk institutions such as specialised mortgage lenders. Table 1 displays the average risk weights across 24 large European institutions as of the 31st of December 2013, as well as the proposed minimum risk weights and assumed average risk weights under the revised standardised approach. It is evident that the biggest increase in risk exposures is seen for residential 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.

TABLE 1

	Institutions	Corporates	Residential real estate	Retail
Average RW - December 31, 2013	20%	48%	15%	47%
Proposed minimum RW - revised SA	30%	60%	25%	75%
Assumed average RW - revised SA	30%	90%	45%	85%
Markup - minimum	1,50	1,25	1,67	1,60
Markup - assumed average	1,50	1,88	3,00	1,81

Source: Financial statements end 2013 for 24 European institutions

5. The consultative document is not clear on the calculation of the new floor and its application to the capital requirement. However, the EMF finds it problematic if the new capital floor results in a floor requirement that is substantially higher than the current temporary floor requirement. Such a scenario would seriously hamper the lending capacity of financial institutions at the expense of lost growth potential for European SMEs for example.
6. If new capital floors are to be introduced, these floors should at the very least not be introduced until all of the other new capital requirements have been implemented and their impacts, both individual and cumulative, have been appropriately analysed. Furthermore a new floor should only serve as a back-stop, even for institutions with high volumes in low risk exposures. In addition, the calculation of such a floor should be kept simple, so that credit institutions using the IRB-approach are not burdened with a complicated supplementary calculation of risk exposures. For instance, at first glance, the complexity and extensive need of data under the suggested revised standardised approach for credit risk appears quite burdensome.
7. Since the financial crisis, the EU's capital requirements framework has been expanded significantly and now consists of strict pillar I requirements, several capital buffers (capital conversion buffer, countercyclical buffer, SII/OUU-buffers (EU) and a systemic buffer), pillar II requirements and, as the BCBS indicates, a leverage ratio. Furthermore, the framework will be complemented by TLAC/MREL requirements. The large number of different capital requirements provides regulators with a very complete 'tool box' with which to require the level of capital they deem appropriate, both for individual banks and for the total banking sector in their respective markets.
8. The introduction of additional requirements in the form of a new standardised approach for credit risk together with a new capital floors framework provides for an additional level of complexity, which could in actual fact be counterproductive in terms of the stated objectives of the BCBS to create a more coherent and integrated capital framework. This is particularly relevant when we consider the very different ways in which the various capital requirements outlined above have been employed across the different jurisdictions and even within the EU.

Specific remarks

9. Regarding question 1 in the consultation paper, it is the EMF's assessment that on the one hand an aggregate floor would be potentially easier to manage; on the other hand, a more granular floor would be more transparent but could be problematic in terms of defining a detailed, harmonised model.
10. If increased granularity is used to level out the effect of a floor on different types of institutions (e.g. mortgage institutions relative to universal banks), the EMF would support further investigation into this type of floor. However, the EMF believes this is better achieved via an adjustment of the proposed risk weights for exposures secured by real estate under the revised standardised approach for credit risk. If floors on exposure classes were to be adopted, it should be at a portfolio level.