

European Mortgage Federation-European Covered Bond Council (EMF-ECBC)

Response to European Commission Exploratory Consultation on Finalisation of Basel III 12 April 2018

General Questions

a) What are your views on the impact of the revisions on financial stability?

We are still forming our views on this question.

b) What are your views on the impact of the revisions on the financing of the economy?

As the European Mortgage Federation-European Covered Bond Council (EMF-ECBC), our responses to this consultation focus specifically on those areas of relevance for the mortgage and covered bond businesses i.e. the revisions to the Standardised Approach for Credit Risk, the Internal-ratings based (IRB) Approaches for Credit Risk and the Output Floor.

To summarise our general impressions: we welcome the revisions to the standard approach for residential real estate exposures which is based on a higher level of risk sensitivity and provides more granular risk weights. With respect to commercial real estate lending, our assessment is different: we are very concerned about the new Standardised Approach which proves to be much more detrimental to this exposure class compared to the former regime, primarily for income producing commercial real estate.

In general, we are very concerned about the impact of the interaction between the revised standardised approach and the output floor for IRB banks, specifically in relation to the low risk and best quality real estate exposures. The application of the output floor to IRB banks will result in a loss of risk sensitivity of residential and commercial mortgage exposures whose final capital requirement will still be driven by a unique risk factor: the LTV. Moreover, this will almost certainly trigger a significant but unwarranted increase in capital requirements for these exposure classes, which would, in our view, constrain banks' ability to lend to the real economy. Finally, a risk of significantly higher capital costs is also triggered by input PDs and LGDs for real estate under the IRB approach. Again, evidence and experience from the past show that the current IRB regime for real estate in the CRR is well calibrated and much better reflects the long-term finance techniques of the real economy of the EU.

More details on these concerns are provided below.

Standardised Approach for Credit Risk

1.1 What are your views on the revisions to the SA-CR?

Our views on the risk weights for residential and commercial real estate exposures under the revised SA-CR are explained in more detail below. However, in terms of general observations:

Firstly, we strongly welcome the formal recognition of the macro-prudential characteristics of the covered bond asset class at global level and the fact that the Basel III recommendations capture the key qualitative features already intrinsic to the European Covered Bond Council's Covered Bond Label. We therefore strongly welcome the new risk weights for rated and unrated covered bonds. We furthermore note and welcome that the issue of over-

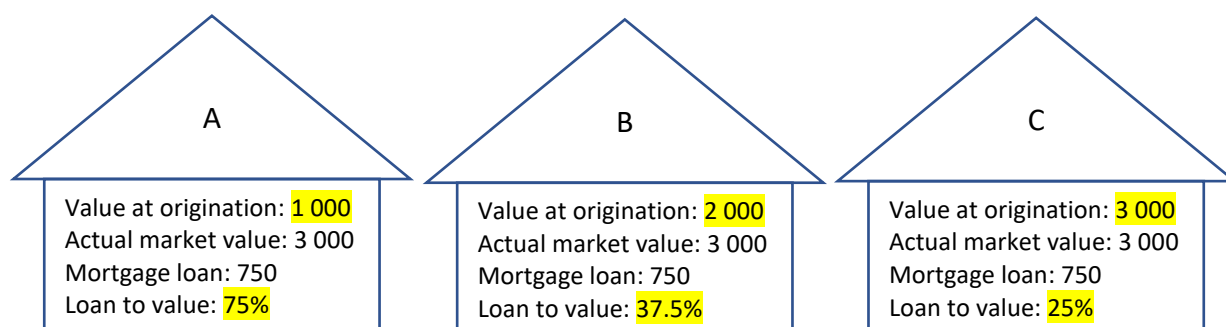
collateralisation is currently being addressed through the amendment of Article 129 CRR in the context of the Covered Bond Legislative Package, taking account of EU specificities.

On a more detailed level with regard to covered bonds, we note that properties securing assets in the cover pool have to be fully completed. Beyond the provided national discretion, it is important that residential loans for housing construction can be included in the cover pool, for so far as the amount of these loans remain in line with that of the underlying mortgaged assets and the LTV is not exceeded.

Secondly, we welcome the introduction of the possibility for “modifications made to the property that unequivocally increase its value”...to also...“be considered in the LTV” in paragraph 62. This is very positive from the perspective of the Energy Efficient Mortgages Initiative, which the EMF-ECBC is leading on, and which is intended to design and deliver a mortgage financing mechanism according to which property owners are incentivised to improve the energy efficiency of their properties by way of favourable financing conditions linked to the mortgage product. We would therefore strongly support the inclusion of this possibility in a revised European capital requirements framework to support the European Commission’s efforts to stimulate sustainable finance. Indeed, this would be very much in line with the European Commission’s commitment in its Action Plan on Sustainable Finance to take sustainability into account when assessing the implementation of the Basel III reforms in Europe.

Related to this, we are therefore concerned about the contradictory value at origination principle in paragraph 62 of the Basel III recommendations. A general 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:

Imagine three identical houses, situated on the same street, with the same loan size, but purchased at three different times and therefore with different value at origination. It is not logical that these houses have different loan to values.



We believe that the general principle should be that, in the same way as described above for cases where an increase in value as a result of modifications made to the property could be considered in the LTV, lenders should have the option to update the value of the property when justified by market developments. 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.

Furthermore, depending on the interpretation and implementation of certain of the criteria in paragraphs 60 and 62 in a European context, these requirements could be of concern, for example, the definition of “prudent value”, which is not a recognised valuation base in Europe. We would therefore advocate maintaining the existing rules regarding property valuation in this respect, which are robust and have proved over time to work very well.

1.2 How would the revisions to the SA-CR impact you/your business and, if applicable, your lending/borrowing behaviour?

We are particularly concerned about the potentially higher risk weights for commercial real estate exposures and the impact these will therefore have on banks' lending abilities. See 1.2.1.b for more details.

1.2.1 How does the revised SA-CR compare to the current approach in terms of capital requirements?

See 1.2.1.b for more details.

1.2.1.b Please provide an estimate if positive or negative difference between the revised SA-CR and the current approach is significant in your view:

Overall, the revisions to the standardised approach present a mixed picture from a mortgage lending perspective. The revisions to the treatment of residential real estate exposures are positive from our perspective, with improved granularity in risk weights, particularly at the lower LTV end of the scale. However, the proposed risk weights remain too high compared to the low risk of this asset class, in particular when compared to the losses incurred by banks in the last 20 years as well as the loss predictions delivered by banks' models. Similarly, the revised risk weights for commercial real estate are problematic and this appears to be across the board i.e. from low to higher LTVs. This particularly applies to income producing commercial real estate where risk weights increase up to 110% for LTVs beyond 80%.

1.2.2 Do the revisions to the SA-CR affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects?

As indicated above, the revisions to the SA-CR, in our view, unduly increase the risk weights for commercial real estate exposures. At a minimum the 0.3% 'hard test' approach in the current CRR should be maintained in order for banks to be able to benefit from lower risk weights where justified by actual loss data.

1.3 Where do you expect particular implementation challenges in the revisions to the SA-CR and why?

See 1.1 and 1.2.1.b.

Internal-ratings based (IRB) approaches for credit risk

2.1 What are your views on the IRB approaches?

Real Estate Exposures:

There is no justification for an input floor at individual borrower or exposure level. If input floors are prescribed for PD and LGD at individual borrower or exposure level, this will result in low-risk transactions being disadvantaged because of the associated higher capital costs which are not appropriate to the risk. There is evidence of residential real estate loans where the PD is in the area of 1 to 4 basis points – for example, exposures to wealthy private clients.

With regard to A-IRB, the interplay between the newly introduced LGD input floor of 10% for the secured part of the exposure and an increased haircut of 40% applied to the value of the collateral value results in slightly lower risk weights for exposures with a higher LTV ratio level. However, compared to the current CRR requirements the revised A-IRB leads to a significant increase of risk weights especially for residential and commercial real estate exposures with a low LTV ratio.

Following the revised requirements, an exposure should be divided into a secured part and an unsecured part. For both parts the LGD has to be calculated considering each with a LGD input floor. This is a massive interference into the freedom of A-IRB methods and causes an enormous technical need for changes. Most institutions use a reliable supervisory method to calculate the LGD, which is not based on the breakdown of the secured and the unsecured part, but which follows a holistic approach of expected proceeds from the sale of real estate in relation to the amount of the exposure in total. This supervisory method should be maintained.

Public sector exposures:

For exposures to the public sector, we understand that it will no longer be possible for banks to use the A-IRB approach (for which many banks have the approval of their respective regulators) and that the F-IRB approach will be the new method from 2022 onwards. According to the proposals, exposures to the public sector will be included in the “Institutions” category (the same category as for exposures to banks), for which a 45% LGD is applied. Such a high LGD is not at all consistent with the low risk business of lending to local governments. A much lower LGD of between maximum 5% and 10%, which would be consistent with the almost zero real credit losses incurred in this business, should be applied to exposures to local governments that are not assimilated to their central governments.

2.2 How would the revisions to the IRB approaches impact you/your business and, if applicable, your lending/borrowing behaviour?

As indicated under 2.1, it is not clear what the impact of the revisions to the IRB will be on capital requirements for real estate exposures.

Regarding public sector exposures, we would expect these changes to have a significant impact on banks’ public-sector lending and, for example, undermine the mission of public development banks to lend to local governments.

2.2.1 How do the revised IRB approaches compare to the current approach in terms of capital requirements?

See 2.2.

2.2.1.b Please provide an estimate if positive or negative difference between the revised IRB approaches and the current one is significant in your view:

See 2.2.

2.2.2 Do the revisions to the IRB approaches affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects?

See 2.2 for our views in relation to the real estate exposure classes and public-sector exposure classes.

2.3 Where do you expect particular implementation challenges in the revisions to the IRB approaches and why?

See 2.1.

Output Floor

5.1 What are your views on the revisions to the output floor?

The 72.5% output floor is of considerable concern because of its potential to adversely constrain banks. The output floor will decouple risk from capital requirements and will, in our view, impact on interest rates and, therefore, economic growth. A capital requirement framework which is less aligned with the models that banks use to control and price risk and on which they base the business decisions may, in the longer term, result in a shift of banks’ portfolios away from the mostly low risk loan segments most affected by this misalignment, and drive banks towards typically riskier loan segments. This could impact financial stability in the banking sector, contrary to the objective of the revised standard.

We would like to underline that the leverage ratio is a more than adequate backstop or ‘safety net’ to risk-based capital requirements for credit risk in order to prevent excessively low capital levels.

5.2 How would the revisions to the output floor impact you/your business and, if applicable, your provision of/access to (bank) financing?

As indicated above and described below in more detail, we are very concerned about the potentially significant impact of the output floor on banks' capital requirements and consider that the increase will adversely affect banks' ability to lend to the real economy.

5.2.1 What would be the impact of the revised output floor in terms of capital requirements when compared to the application of the revised internally modelled approaches?

Our member banks are still carrying out analyses to understand the impact of the output floor on their loan portfolios and therefore capital requirements, however, preliminary indications suggest that there will be a significant increase in capital requirements. Indeed, it has been suggested by some of our member banks that there will be as much as a 10-fold increase in capital requirements for the best quality assets in IRB banks' portfolios. More detailed analysis will be provided in due course. See 5.2.2 for more explanation here.

5.2.1.b Please provide an estimate if the positive or negative difference between the revised output floor and the application of the revised internally modelled approaches is significant in your view:

See 5.2.1.

5.2.2 Does the application of the revised output floor affect certain assets/exposure classes more than others and – if applicable – which of the provisions of the revised framework may create these effects?

The indications from preliminary analyses run by some of our member banks are that IRB banks with low-risk portfolios (and low risk weightings) will be unduly and unintentionally affected. This is almost certainly the case for mortgage banks with high proportions of low-risk-weighted mortgage loans. Furthermore, this impact on IRB risk-weighted assets is identified even applying the lower risk weights for low LTV residential real estate exposures, for example, under the revised standardised approach compared to the current approach.

5.3 Where do you expect particular implementation challenges in the revisions to the output floor and why?

See above.