

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

Response to European Commission Consultation on Implementing the Final Basel III Reforms in the EU

16 December 2019

1.1.6 Real estate (RE) exposures

1.1.6.1 Implementation of loan splitting (LS) approach vs whole loan (WL) approach

Issue: The Basel III standards provide two alternative approaches for assigning RWs to real estate (RE) exposures: The LS approach splits mortgage loans into a secured and an unsecured part (implicitly using the loan-to-value (LTV) ratio) and assigns a different RW to each of these two parts, thereby conceptually following the current approach of the CRR (Articles 124 to 126). The WL approach considers mortgage loans as specific products and assigns a RW to the entire exposure based on its LTV ratio using different LTV buckets. The rationale for using the LTV ratio as risk driver for determining the applicable RWs is that the losses incurred in the event of a default and the likelihood of a borrower's default are lower when the outstanding loan amount relative to the value of the RE collateral (i.e. the LTV ratio) is lower. However, only the LS approach is also sensitive to the type of borrower (as it applies the RW of the counterparty to the unsecured part) and reflects the risk mitigating effects of RE collateral in the applicable RWs even in case of high LTV ratios.

Question 34. Views are sought on the relative costs and benefits of the LS approach and the WL approach provided by the final Basel III standard.

In particular, how do the two approaches compare in terms of risk-sensitivity, impact on RWAs and operational burden?

The loan splitting approach in the CRR has the advantage that it avoids sharp discontinuities when a loan moves into the next LTV band i.e. it gives a smoother correlation between LTV and effective risk weights.

However, from a risk sensitivity perspective, the loan splitting approach as proposed in the Basel standard completely ignores any effect of the real estate collateral above LTV 55 %. For institutions primarily concentrated on lending in the 55-80 % LTV band the loan splitting approach could be unduly penalising.

Any requirement that the risk weight be assigned to the total exposure amount would result in the introduction of cliff effects. The impact of the whole loan or the loan splitting approach on RWAs depend on the specific mortgage model and as there are different mortgage business models by historic mortgage lending traditions there is not one preferred approach and it should be possible for the single bank to apply for the preferred approach.

Question 35. Would you deem further refinements or clarifications necessary concerning the approach that you generally prefer?

Yes

Question 35.1 If yes, what would those be and what would be their prudential rationale?

We consider that the calibration of the risk weight for loans secured by real estate in the Basel standard does not appropriately reflect European conditions. In Europe low risk mortgage loans are kept on the balance of banks, which justifies lower risk weighting for mortgage loans, compared to the risk weighting of mortgage loans in jurisdictions where low risk mortgage loans are removed from the balance sheet of regulated entities by means of Government sponsored entities. Therefore, we find it justified to include further refinements for the two approaches available for institutions in the European legislation.

We suggest further refinement to the loan splitting approach. The risk weight in the 55-80% LTV band based on the risk weight of the counterparty should be reduced by a factor of [X%] to reflect that the loan is fully and completely secured by the real estate property. The risk weight under the loan splitting approach to a retail customer with an unsecured risk weight of 75% should thus be reduced to [75%-X%] in the 55-80% LTV band.

We believe it would be risk-appropriate if the criterion whereby repayment of a loan should not be dependent on cash flows from real estate collateral were substituted in European implementation by the hard test for income producing residential real estate exposures according to Art. 125(3) CRR. Indeed, the dual recourse nature of mortgages in the EU, as opposed to practice in other global jurisdictions, together with the low losses incurred by banks, justify the lowering of risk weights, under both the whole loan and loan splitting approaches.

Similarly, the revised risk weights for commercial real estate are problematic, where repayment of a loan is either dependent on or not dependent on cash flows from the collateral, and this appears to be across the board i.e. from low to higher LTVs. Commercial real estate will only have two buckets for risk weights (one for LTV below 60% and one for LTV above 60%). The economically motivated distribution of risk is not nearly appropriate enough particularly in the low LTV buckets. For example, finance with an LTV ratio of $\leq 50\%$ is assigned the same risk weights as finance with an LTV ratio of 60% (risk weight of 60% where independent of cash flows and 70% where dependent on cash flows). The specified risk weights need to be made more risk-appropriate. For income producing commercial real estate where risk weights increase up to 110% for LTVs beyond 80% actual loss data indicates that increased granularity for lower LTVs would be justified. In the case of commercial real estate finance where repayment of a loan is not dependent on cash flows from collateral, further differentiation could be achieved by, for example, an additional LTV $\leq 50\%$ bucket with an appropriate risk weight of 50%. Like the whole loan approach, the loan splitting approach would also have to be adjusted. This could, for example, be achieved by lowering the risk weight also to 50% for the portion of finance that is regarded as secured (LTV ratio $\leq 55\%$).

At a minimum, the 0.3% 'hard test' approach in Art. 126(3) CRR should be maintained for banks to be able to benefit from lower risk weights where justified by actual loss data. This approach is included in the Basel III framework in footnote 49 of paragraph 73 p. 24: "For such exposures, national supervisors may allow banks to apply the treatment described in paragraphs 70 to 71 subject to the following conditions: (i) the losses stemming from commercial real estate lending up to 60% of LTV must not exceed 0.3% of the outstanding loans in any given year and (ii) overall losses stemming from commercial real estate lending must not exceed 0.5% of the outstanding loans in any given year. If either of these tests are not satisfied in a given year, the eligibility of the exemption will cease and the exposures where the prospect for servicing the loan materially depend on cash flows generated by the property securing the loan rather than the underlying capacity of the borrower to service the debt from other sources will again be risk weighted according to paragraph 73 until both tests are satisfied again in the future. Jurisdictions applying such treatment must publicly disclose whether these conditions are met."

We would also recommend introducing preferential treatment for exposures collateralised by the production sale generated by the financed investment where the revenues from the production sale are automatically and directly transferred to the lending bank.

Question 36. What would justify implementing both approaches in parallel from a risk perspective?

If both approaches were to be implemented and made available on discretionary basis, how would comparability across institutions be ensured and how would regulatory arbitrage as well as undue complexity be prevented in this case?

We do not see a significant regulatory arbitrage risk if both approaches were to be implemented since the choice between both approaches is rather determined by historic mortgage lending traditions and the treatment of real estate as a collateral tool. Each bank should be permitted to apply for the approach which most appropriately reflects their business model and historic traditions regarding mortgage finance

1.1.6.2 Treatment of exposures where the servicing of the loan materially depends on the cash flows generated by a portfolio of properties owned by the borrower

Issue: The Basel III standards introduce a specific RW-treatment for RE exposures where the prospects for servicing the loan materially depend on the cash flows generated by the property securing the loan rather than on the underlying capacity of the borrower to service the debt from other sources (so-called “income producing real estate (IPRE)). This modification is intended to reflect the associated risk more accurately and improve consistency with the treatment of IPRE under the IRBA. According to the SA-CR standards “[t]he distinguishing characteristic of IPRE versus other corporate exposures that are collateralised by real estate is the strong positive correlation between the prospects for repayment of the exposure and the prospects for recovery in the event of default, with both depending primarily on the cash flows generated by a property securing the exposure” (see paragraphs 67 and 73). The default approach laid down in the Basel III standards for assessing whether such a strong positive correlation exists is to look at the cash flows generated by the respective individual property in relation to all other cash flows of the borrower. However, the Basel III standards also contain a discretion to conduct this assessment by checking whether the servicing of the loan materially depends on the cash flows generated by a portfolio of properties owned by the borrower.

Question 37. Do you consider the assessment of the condition of “strong positive correlation” on a portfolio basis more appropriate than the assessment based on the individual RE exposure?

No

Question 37.1 If no, please elaborate on your response to question 37.

The discretion in footnote 50 regarding paragraph 73 should be applied as follows to determine when the loan materially depends on the cash flows generated by the financed property. The cash flows generated by the financed property should be compared with the total cash flows generated from all sources of the borrower. The cash flows generated by the financed property (CF_{RE}) should not include the cash flows generated by other properties of the borrower. The risk of a real estate exposure cannot be accurately measured by assuming that the cash flows of all properties in the borrower’s portfolio have a strong positive correlation. On the contrary, the effects resulting from diversification decrease the risk of the real estate exposure and do not increase it. Thus, the cash flows of the portfolio of properties should only be taken into account when determining the borrower’s total

cash flows (CF_{Total}). The repayment of a loan would be materially dependent on cash flows of the financed property if more than 50% of CF_{Total} is generated by the financed property (CF_{RE}).

Question 38. If the assessment based on a portfolio basis were introduced, what are your views on whether it should be the only approach available in the Union or it should be an alternative approach to be applied at supervisory discretion on a case-by-case basis?

- It should be the only approach available in the Union
- it should be an alternative approach to be applied at supervisory discretion on a case-by-case basis
- Don't know / no opinion / not relevant

Question 38.1 Please explain your response to question 38.

The treatment described in our comment regarding question 37 should be the only approach available in the EU. Different requirements should be avoided due to competitive reasons. Supervisory discretion would result in more complexity and administrative burden.

1.1.6.3 Eligibility of property under construction

Issue: According to the Basel III standards, in order for mortgage loans to be eligible for the preferential treatment provided for the RE exposure class, among others, the property securing the exposure must be 'fully completed' (see paragraph 60). At the same time, the Basel III standards provide a discretion to treat loans to individuals that are secured by residential property under construction as RE exposures. However, this preferential treatment is only available provided that the property under construction is a one-to-four family residential housing unit that will be the primary residence of the borrower (this does not include apartments within a larger construction project) or where the sovereign or PSEs have the legal powers and ability to ensure that the property under construction will be finished (see paragraph 60). Owner-occupied RE is supposed to have a lower credit risk, since the owner is expected to be more motivated to repay the loan for his/her own residence compared to other loans. The number of housing units within a property under construction that can be recognised as collateral is set at four, to take account of the situation that own-occupied houses are sometimes built with separate units for more than one family generation.

The current CRR already reflects the lower credit risk of owner-occupied RE, but without setting a clear threshold for the number of property under construction (Article 125).

Question 39. What are your views on the costs and benefits of implementing the preferential treatment for certain properties under construction as provided by the Basel III standards?

We welcome the recognition of property under construction as RRE, but we think that the criteria listed in paragraph 60 of the Basel text are too prescriptive. E.g. if a borrower has to move because of his job, it is not possible for a bank to influence his primary residence.

Question 40. Do you consider the threshold of one-to-four family residential housing units appropriate?

No

Question 40.1 if not, which other threshold would you consider to be more appropriate? Please provide evidence supporting your view.

Current CRR rules do not limit RRE to one-to-four family residential housing. We advocate to keep this open requirement. Otherwise exposures to natural persons would get a risk weight of 100% (75% if the exposure is less than 1 mn). Exposures to corporates would be attached to ADC and get a risk weight of 150% (in special cases 100%). We do not consider this increase of 329% adequate.

1.1.6.4 Prudently conservative valuation criteria

Issue: The Basel III standards no longer distinguish between the market value (MV) concept and the mortgage lending value (MLV) concept for determining the value of RE collateral, but set out some general valuation criteria in paragraph 62 in order to simplify the treatment of RE exposures and make it more robust: “[T]he valuation must be appraised independently using prudently conservative valuation criteria. To ensure that the value of the property is appraised in a prudently conservative manner, the valuation must exclude expectations on price increases and must be adjusted to take into account the potential for the current market price to be significantly above the value that would be sustainable over the life of the loan. National supervisors should provide guidance setting out prudent valuation criteria where such guidance does not already exist under national law. If a market value can be determined, the valuation should not be higher than the market value”.

Question 41. Views are sought on the costs and benefits of the valuation criteria provided by the Basel III Standards.

In particular, how does this approach compare with the current approaches available under the CRR (MV and MLV) in terms of simplicity, comparability, risk-sensitivity, impact on RWAs and operational burden?

The CRR provides optionality based on legal definitions and recognised value bases, namely the market value and the mortgage lending value. Both approaches are enshrined in European and International Valuation Standards and are transparent, consistent and well established, having been applied by the valuation profession and the credit industry across Europe for decades.

The Basel III standards state that the valuation must be appraised in a prudent and conservative manner, excluding expectations on price increases, and adjusted to take into account the potential that the current market price is significantly above a sustainable value over the life of the loan. In our opinion, both the ‘mortgage lending value’ and ‘market value’ methodology fit with the Basel requirements. The ‘market value’ delivers an estimated amount for which a property should exchange according to a knowledge-based, non-compulsory arm's-length transaction between independent agents in the real estate market. The market value allows valuers to detect market speculation by using historic market data and therefore to appropriately contextualise the market value in the market cycle. Furthermore, in many Member States national legislation complements the market value with certain conservative rules. For these reasons, the ‘market value’ can also be considered to be aligned with the requirements of prudential, conservative and sustainable valuation.

The large majority of EU Member States apply a market value-based approach and European valuers are trained to carry out this kind of valuation. Any changes to current valuation principles in all markets across the Union would be extremely difficult and complex from an operational perspective, and certainly not achievable over a short timeframe, and could give rise to market disruption. Consequences for European real estate markets must be thoroughly analysed, an exercise which is complex and time-consuming and would require specific training of

valuers. Any changes of valuation bases would also have significant impacts on important, internationally recognised, long-standing valuation methodologies, such as the discounted cash flow and income methodologies, given the consequent uncertainty for valuers regarding how possible future market developments should be taken into account. Finally, valuation approaches must be consistent across the whole loan book and the value chain. Banks cannot apply different valuation criteria for the same asset depending on the purpose of the loan or the stage of the lending process. Thus, operational burden, legal uncertainty and market disruption would be disproportionate in relation to any aim of changing to new, untested valuation criteria.

In summary, a change in the valuation base could have the following negative impacts: (i) market disruption as result of: (1) a general increase of RW due to the fact that mortgage portfolios would be assigned to buckets with higher RW within the real estate asset classes (RRE and CRE), (2) a lack of understanding of the values delivered using the proposed criteria on the part of market participants and (3) difficulties in managing past and new valuations in the same loan book based on different criteria and methodologies (ii) operational burden linked to the modification of IT systems to monitor the value of real estate and the need to retrain valuers; (iii) a possible mortgage credit crunch due to the new LTV assessment.

In light of these considerations, it is extremely important to maintain the current option in CRR to apply market value or mortgage lending value to value real estate in CRE or RRE in order to ensure that valuations are based on proven standards and implemented by qualified valuers based on a long-term data basis.

Question 42. Would you deem additional specifications necessary to clarify how the MV or the MLV currently used by institutions would need to be adjusted to meet the valuation criteria provided by the Basel III standards?

Would you deem further clarifications necessary to ensure a consistent application of the valuation criteria across the Union?

We see no need for adjustments.

Question 43. What other measures could be taken to ensure that the value of RE collateral is sustainable over the life of the loan?

In our view, what is most relevant and important from a systemic point of view is that a value is as accurate as possible at any given moment in time. In this respect, an additional measure to ensure this would be to reinforce the monitoring requirements for residential property and bring them in line with the requirements for commercial property i.e. monitoring on a yearly rather than a 3-yearly basis.

If the broader concern here relates to the management of market volatilities more generally, we would like to draw attention to the full macro-economic toolkit already at the disposal of supervisors and Member States. Indeed, in recent years, supervisors across the EU have introduced a number of instruments depending on the Member States, including hard LTV limits, LTV restrictions in relation to the overall mortgage portfolio, specific requirements for buy-to-let lending, higher capital requirements (higher risk weights), higher capital buffers etc. Arguably, these tried and test instruments, which are furthermore deployed according to market characteristics and therefore needs, are the most efficient and proportionate way of managing market volatilities and real estate risk.

We would also like to draw attention to the Energy Efficient Mortgages Initiative (EEMI) in this respect. One of the key objectives of the Initiative, on which the EMF-ECBC leads, is to integrate building energy performance

aspects into valuation practices and therefore values. Via a voluntary Valuation Checklist delivered by the EEMI, valuers are provided with a set of tools which can be used to undertake sufficient due diligence, including in relation to building energy performance features, to accurately provide an estimate of value and to comment on these features in their report. This tool has the potential to support more robust real estate collateral values as the energy performance of buildings becomes more and more important in line with the COP objectives.

Question 44. In your view, which other aspects, if any, should be considered in the context of revising the valuation criteria for RE property?

Increasingly, advanced statistical valuation models are widely used and relevant in the context of the valuation of residential real estate (RRE). Against this background, we believe there is good reason to avoid any doubt by clarifying that the use of advanced statistical valuation models is allowed for both at origination and at revaluation, under the supervision of valuers, in order to maintain efficiency of valuation processes. Indeed, it is important that regulators move in a direction that supports smarter and more automated valuations in situations where real estate markets are well established. The use of advanced statistical valuation models (not indexation) and registered data is increasing, creating more reliable data, which should be supervised and back-tested by qualified valuers on a regular basis. It therefore makes sense for such models to be put on the same footing as manual valuations and considered as independent.

1.1.6.5 (Re-)valuation: value at origination vs. current value

Issue: The Basel III standards state that the value of the property recognised for prudential purposes has to be capped at the property value measured at loan origination to reduce the possible cyclical effects of the valuation and keep own funds requirements for RE exposures more stable.

However, the current CRR (Article 208) requires the monitoring and, where indicated, the revaluation of RE collateral without preventing possible value adjustments upwards to reflect the increase in market value in particular where mortgage loans have long maturities.

Question 45. Views are sought on the costs and benefits of capping the property value at loan origination.

In particular, how does the approach provided by the final Basel III standards compare with the current approach of the CRR in terms of possible cyclical effects on RWs, risk- sensitivity, impact on RWAs and operational burden?

We are very concerned about the ‘value at loan origination’ principle of the Basel III Standard. A general requirement to keep the value of the property constant as measured at loan origination in the calculation of the LTV would oblige lenders to ignore variations in property values over the longer term. This would result in, for example, 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, having different loan to values, resulting in different risk weights.

Value at loan origination would also incentivise riskier outcomes when the borrower is considering refinancing. Indeed, for the same loan (amount) and the same property, the risk weight (and therefore pricing) applied by a new lender could be lower if there has been an increase in the property value since the original loan was granted, as the new lender will – and must - use the latest valuation, while the original lender cannot. The risk however remains the same. This would almost certainly result in arbitrage, according to which lenders will redocument and re-advance the loan in order to benefit from the new valuation.

An additional consequence that would arise from the capping of the RE value at loan origination is the significant impact that it could have for investment / construction loans. The collateral for these loans is the properties that will result once the developer has completed the construction(s) / refurbishment. Usually, at loan origination, the value of the collateral is very low compared to the fully developed one. For construction loans you could argue that the fully developed property is legally different from the one that was initially taken as collateral. For example, the original collateral is a vacant land plot, but at the end of the development, the collateral is land plus construction. This means that although there is a possibility to update the market value of the property (as the new property is a different one from a legal point of view), practically a loan cannot be granted for the equity required at different construction stages. In conclusion, by capping the value at origination the same lender cannot increase the loan until the property is completed. We believe loans for refurbishment / renovation will be more affected than construction loans as there is no legal differentiation between fully refurbished / renovated properties and ones in need of full refurbishment / renovation.

The value at loan origination principle would also disadvantage SA lenders compared to IRB lenders in the EU, as an IRB lender is able to take account of the current value of the property for the purpose of determining the LGD.

The general principle should be, as is currently the case in the CRR, that lenders should have the option to update the value of the property, also upwards, 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. Indeed, if LTVs are to be the key determinant of risk weights, they should be accurate.

Allowing for this possibility is all the more justified when considering the fundamental differences between EU and US residential mortgage markets, where the latter are characterised by 'originate to distribute' practices, unlike in the EU, where mortgages are held on banks' balance sheets.

1.1.1.6 Land acquisition, development and construction (ADC) exposures – general treatment

Issue: With a view to increasing the risk sensitivity and robustness of the SA-CR, the Basel III standards introduce ADC as a new subset of RE exposures, which includes loans financing any of the land acquisition, development or construction of any properties where the source of repayment at origination of the exposure is either the future uncertain sale of the property or cash flows whose source is substantially uncertain (e.g. the property has not yet been leased to the occupancy rate prevailing in that geographic market for that type of real estate). ADC exposures are to be risk-weighted at 150% unless they meet certain criteria (see below 1.1.6.7.).

Similarly, the CRR currently requires the application of a 150% RW to 'speculative immovable property financing' (Article 128) which includes "loans for the purposes of the acquisition of or development or construction on land in relation to immovable property, or of and in relation to such property, with the intention of reselling for profit" (Article 4(1) (79)). Financing solely the acquisition of finished immovable property where the properties are acquired for resale purposes is hence to be treated as speculative immovable property financing under the CRR, but would not be included in the scope of ADC under Basel III, as the latter only refers to the acquisition of land for development and construction purposes but not to the acquisition of immovable properties.

Question 48. What are your views on the costs and benefits of replacing the existing treatment of 'speculative immovable property financing' with the treatment of ADC exposures as provided by the Basel

III standards?

It is vital that ADC exposures are appropriately treated in order to avoid penalising the financing of new housing and commercial buildings.

We welcome the fact that Basel III considers that exposures be classified as ADC exposures only when there is insufficient other income or assets of the obligor to mitigate the risk of losses (for instance, when the source of repayment of loans depends mainly on the cash flow generated by the real estate that is being financed). In our view, in the other cases, exposures should be considered as a corporate or retail SMEs exposures, with risk weights depending on the creditworthiness of the counterparties.

We furthermore welcome the fact that the acquisition of finished properties for resale purposes is not treated as ADC under Basel III. Indeed, in the case of finished properties, the risk is much lower than for properties under construction. The completion risk (default risk of the developer), one of the most substantial risks for lenders at the beginning of the value chain, no longer exists.

Question 49. Would you deem further refinements or clarifications necessary concerning the scope or definition of ADC exposures?

No

Question 49.1 If no, please elaborate on your response to question 49.

See above

1.1.6.7 ADC exposures – conditions for the application of 100% RW

Issue: The Basel III standards allow for the application of a preferential RW of 100% to ADC exposures where the general underwriting requirements applicable to RE exposures are met and the following condition is fulfilled: *“Pre-sale or pre-lease contracts amount to a significant portion of total contracts or substantial equity at risk. Pre-sale or pre-lease contracts must be legally binding written contracts and the purchaser/renter must have made a substantial cash deposit, which is subject to forfeiture if the contract is terminated. Equity at risk should be determined as an appropriate amount of borrower- contributed equity to the real estate’s appraised as-completed value”* (paragraph 75). The meaning of the terms ‘significant portion of total contracts’, ‘substantial equity at risk’ and ‘substantial cash deposits’ is not further specified.

Question 50. In relation to the condition for applying the preferential risk weight of 100% to certain ADC exposures, do you consider further specification necessary to ensure a harmonised application of this condition across the Union, for example by defining or quantifying any of the terms mentioned above?

We welcome the fact that under Basel III, when pre-sale or pre-lease contracts amount to a significant portion of total contracts (e.g more than 30% for residential assets), ADC exposures shall not be identified as high-risk exposures. Indeed, it is important to ensure a narrow definition of high-risk ADC exposures that will be associated with a 150% RW. An excessively broad definition of high-risk ADC exposures would not capture the risks of this kind of exposures with an adequate level of risk-sensitivity.

1.1.5 RW multiplier to certain exposures with currency mismatch

Issue: The Basel III standards introduce a 1.5 multiplier for the RW applicable to “retail and residential RE exposures to individuals where the lending currency differs from the currency of the borrower’s source of income” and where the borrowers have no natural or financial hedge against the foreign exchange risk resulting from the aforementioned currency mismatch. The resulting maximum RW to be applied is capped at 150%. Neither the Basel II standards nor the CRR contain a comparable provision. This provision is meant to address the higher credit risk that is deemed to be associated with exposures with a currency mismatch compared to those without currency mismatch.

Question 51. What are your views on the costs and benefits of introducing the RW multiplier described above?

Please elaborate and provide relevant evidence to substantiate your views.

Experience to date, primarily through the transposition of the Mortgage Credit Directive (MCD), indicates that legislative efforts to address concerns regarding currency mismatched loans which increase risk for lenders, as is the case under the provisions of the MCD, result in lenders withdrawing from this market, excluding certain categories of consumers from access to credit e.g. those living and working in border areas. Arguably such measures were intended to address the speculative lending practices seen in certain Member States but have resulted in unintended consequences, impacting lending activities which are now captured within the definition of a ‘foreign currency loan’. A RW multiplier would in our view compound this problem and, in those cases where lenders remain in this market, would increase the cost of the loan and result in higher financial burden for the consumer.

If a multiplier for RW to exposures with currency risk will be included in the European transposition of the Basel III standards the multiplier should not be applied to ERMII currency pairs.

Question 52. In your view, what other measures could be taken to address the risks associated with currency mismatches?

In our view, a careful balance should be struck here between seeking to address problems experienced in certain Member States as a result of speculative foreign currency lending, where there was neither a link between the currency in which the borrower received his/her income nor a link between the currency of the Member State in which the borrower resided, and those cases where the exchange rate risk is extremely low because of the connection that those borrowers have with the currency in which the credit is granted either through salary or residence.

In the context of the review of the MCD, we proposed an amendment to the definition of a ‘Foreign currency as follows:

(a) denominated in a currency other than that in which the consumer receives the income or holds the assets from which the credit is to be repaid; ~~or~~ AND

b) denominated in a currency other than that of the Member State in which the consumer is resident.

We proposed that the consumer should still be warned of any potential risk before the conclusion of the contract, especially in case the consumer’s income situation were to change. The ongoing monitoring obligations and the right to convert should however not apply in these situations.

1.1.5 Other provisions

Question 59. In your view, which other aspects, if any, should be considered in the context of revising the SA-CR?

Please elaborate and rank your answers from the most important to the least important aspect.

It is very positive that the Basel Committee recognised covered bonds for the first time as a separate and high-quality asset class with preferential treatment compared to unsecured exposures to banks. We would expect that the new harmonised European framework for covered bonds (the Covered Bonds Directive and amendments to Art. 129 CRR) as adopted by the Council and the European Parliament in 2019 will form the basis for the EU implementation.

With regard to the treatment of covered bonds in the IRB models, we suggest maintaining the current treatment defined in the CRR.

Finally, a significant number of covered bonds issued in the EU are not rated by an external rating agency. In accordance with the finalised Basel III standards, the risk weights for unrated covered bonds would be inferred from the issuer's risk weight. However, some issuing institutions are unrated. In the EU exposures to unrated institutions are currently subject to the country of incorporation principle (Article 121 CRR). Institution exposures are assigned a risk weight in accordance with the credit quality step to which exposures to the central government of the jurisdiction in which the bank is incorporated are assigned. For example, the risk weight of unrated German banks is currently 20%. The revised standardised approach for credit risk includes a new procedure for calculating the risk weight of exposures to institutions with no external rating: the standardised credit risk assessment approach (SCRA). Where all grade A criteria are met, a risk weight of 40% may be applied. For grade A, application of a risk weight of 30% is also possible, provided that the bank has a CET1 ratio of 14% or higher and a leverage ratio of 5% or higher. In reality, most banks do not meet these criteria, so that the reduced risk weight will rarely be applied. Consequently, the risk weight for exposures to, in this case, unrated German banks would double from currently 20% to 40%, which would not be appropriate to the risk. Thus, the risk weight of these covered bond double from currently 10% to 20%. The country of incorporation principle currently applied should therefore be retained in the EU.

6. Output Floor

6.1. Material Scope of Application

Issue: The OF introduced by the Basel III standards intends to ensure that institutions' own funds requirements do not fall below 72.5% of the own funds requirements derived under the standardised approaches. More specifically, the floor applies to institutions' calculations of RWAs which in turn are to be used for the calculation of the applicable own funds requirements in order to reduce excessive variability of RWAs and to enhance the comparability of risk-based capital ratios. In terms of own funds requirements that need to be calculated on the basis of floored RWAs, the Basel III standards refer to the Pillar 1 requirements, the capital conservation buffer requirement, the countercyclical capital buffer requirement, as well as the buffer requirements for global systemically- important and, respectively, other systemically-important institutions (G-/O-SIIs) and the total loss-absorbing capacity (TLAC) requirements. However, in addition to the above- listed requirements, the risk-based capital framework in the EU currently also includes the systemic risk buffer (SRB) and Pillar 2 requirements (P2R).

Question 177. What are your views on the relative costs and benefits of including in the calculation of the OF more own funds requirements than those explicitly mentioned in the Basel III standards?

In particular, how would such broader material scope compare to the scope required by the Basel III standards in terms of impact on RWAs, risk-sensitivity, comparability, complexity and operational burden?

If the output floor is implemented in Europe in a way that includes the additional European capital requirements (buffer requirements for other systemically-important institutions, for systemic risk and for Pillar 2) in the calculation it would fundamentally change the European capital requirement framework. The output floor would not act as a backstop affecting only outlier banks as intended by the Basel Committee.

The recently published EBA quantitative impact assessment shows that on average, EU banks face a minimum required capital (MRC) increase of 24.4%, as indicated above far exceeding the maximum 10% ceiling committed to by the Basel Committee, translating into a capital shortfall of 135 EUR bn. The highest impact comes from the implementation of the Output Floor (+9.1%). However, in this respect and as described by Copenhagen Economics in its recently published Impact Analysis on Proposed Basel III Finalisation in the EU¹, it is important to highlight that banks cannot operate on the absolute minimum required capital. National authorities provide Pillar 2 guidance and the ECB an additional management buffer, but further capital should also be available for additional investor requirements and credit growth. Therefore, the calculation of the capital increase triggered by the output floor must be based on the current average common, equity ratio (CET1) of the European banking sector which is 14.4%, i.e. including all current capital buffers in place. To sustain the current balance sheet structure, the output floor impact would lead to a capital increase of around EUR 400 bn, probably even of EUR 520 bn, i.e. four times more than EBA's estimates.

Furthermore, according to the EBA quantitative impact assessment, mortgage banks experience the highest increase in capital requirements (20%-25%) and report the output floor as the single most important driver of the impact. This finding is borne out by Copenhagen Economics², which indicates that the Basel framework will primarily increase capital requirements for low-risk portfolios, despite evidence that the capital needs of these are based on conservative assumptions. Additionally, across EU Member States, the highest impact is measured in Sweden, reaching a 55% MRC increase, mostly driven by the output floor (around 45 p.p.). Denmark and Germany follow, with an impact of around 40%, of which approximately half is driven by the output floor.

The result would be a severe loss of risk-sensitivity in the capital requirements for a wide section of European IRB banks and a substantial increase in overall capital requirements compared to their counterparts worldwide. This would especially affect the core lending activity of low-risk European mortgage lenders. Hence, such implementation would violate the overall target that the amended Basel III capital requirements should not trigger significant capital increases in general. It could furthermore result in the creation of an un-level playing field between the EU and US and negatively affect EU banks' competitiveness. A further consideration highlighted by Copenhagen Economics³ is that there is evidence (BIS 2010 and IMF) that the additional benefit for advanced economies of increasing capital ratios above 15%, in terms of reducing the risk of a crisis, is small. Beyond this level, further capital increases have only marginal effects on crisis prevention. Balancing out capital levels around 15% (and not more) translates into a net societal impact (annual net GDP growth of 0,1%).

Finally, less risk sensitive capital requirements weaken the incentives for IRB banks to lend to low risk customers and increase the incentives for high-risk lending. This can put upward pressure on the cost of mortgage lending for both households and corporates, and ultimately have negative consequences for financial stability.

Question 178. Would you deem further refinements or clarifications necessary concerning the material

¹ [See page 21.](#)

² [See pages 25-28.](#)

³ [See page 40.](#)

scope of the OF?

Yes

Question 178.1 If yes, what would be their prudential rationale? Please elaborate and provide relevant evidence.

*We propose that, if the output floor is included in the EU financial legislation, it should be implemented as one of three **parallel** capital requirements:*

- (1) The risk-based requirement applying RWA calculated using approved internal models and standardised approaches as applicable (based on all EU and nationally set requirements);*
- (2) The output floor requirement applying RWA calculated as 72.5% of RWA using standardised approaches only (based on Basel III requirements only);*
- (3) The leverage ratio requirement.*

All three capital requirements should be fulfilled. The constraining capital requirement (the requirement that results in the highest own fund requirement) will be decisive for the risk sensitivity of the capital requirement framework for the bank.

This implementation can be inferred from the Basel Committee's accord text, paragraph 1 of the dedicated output floor section. The text states that the output floor "will ensure that banks' capital requirements do not fall below a certain percentage of capital requirements derived under standardised approaches". Indeed, within this implementation, the constraining capital requirement (the requirement that results in the highest own fund requirement) will be decisive for the risk sensitivity of the capital requirement framework for the bank.

With this approach, significant increases in capital requirements for most EU IRB banks could be avoided and any potential over capitalisation not based on risk would be limited to actual outlier banks. This would be in alignment with the intention of the final Basel III framework not to give rise to significant increases in capital requirement. Furthermore, the additional complexity of this approach will be modest, similar to introducing the additional leverage ratio requirements for banks.

This implementation would be fully compliant with the aim of the output floor in Basel Committee framework and result in the output floor working as a capital backstop for most European banks as intended, rather than the constraining requirement. It will, in a significant way, minimise the detrimental effects of the implementation of an output floor in Europe. Furthermore, it would also make it possible for authorities that wish to increase capital requirement buffers for banks in their jurisdiction to keep capital requirements fully risk-based.

With the application of the full RWA output floor, the capital requirements resulting from Pillar 1, the buffers and the SREP add-ons (Pillar 2) would all rise significantly. As indicated above, evidence from the EBA suggests that the application of the output floor to the full stack would trigger minimum required total capital increases of 24.4% for all EU banks. The risk sensitivity of the capital requirements from internal models would be eliminated. If the output floor is implemented in Europe in a way that includes the additional European capital requirements in the calculation of the output floor capital requirement, the example shows that it could be binding requirement for a typical European IRB bank and not work as a backstop capital requirement, only affecting outlier banks as intended.

Arguably, this implementation would represent a “gold plating” of the Basel standards. The EU specific elements go beyond the capital requirements in the Basel framework, and should therefore not be used for the calculation of the output floor requirement.

The hybrid RWA output floor would only give a minor reduction of the capital requirement compared to the application of a full RWA output floor. The hybrid RWA output floor still includes the additional EU capital requirements in the output floor calculation. The floor could still be the binding requirement for a typical European IRB bank, and thus not work as a backstop requirement for outlier banks as intended. The risk sensitivity of the capital framework would be very significantly reduced under this approach.

6.2 Level of Application

Issue: The Basel III standards do not specify the level of application of the OF.

Question 179. Views are sought on the relative costs and benefits of applying the OF at all levels of the banking group (i.e. individual, sub-consolidated and consolidated) or solely at the highest level of consolidation in the EU.

In particular, how do the two approaches compare in terms of impact on RWAs, comparability, complexity and operational burden?

If the output floor is implemented into European legislation, it should be applied at the highest level of consolidation. This would be simpler, because each banking group would only have to calculate the output floor once and it would avoid the risk of further fragmentation of the banking market that application at individual level would engender. Furthermore, application at individual level would reduce banking groups’ flexibility when allocating capital internally and undermine risk diversification at group level, without adding any value in terms of sound risk management.

6.3 Transitional Measures

Issue: The Basel III standards foresee a 5-year transitional path for institutions to grow into and adjust to the new requirement, as well as the possibility of a “transitory cap” that temporarily prevents that RWA increase more than 25% because of the OF.

Question 182. In your view, should both of the transitional measures provided by the Basel III standards be implemented in the EU?

Yes

Question 182.1 If yes, please elaborate on your response to question 182.

If the full RWA output floor were to be implemented in the EU, both of the transitional measures provided by the Basel III standards would be indispensable in the EU.

Question 183. Would you deem further refinements or clarifications necessary concerning the transitional measures?

Yes

Question 183.1 If yes, what would be their prudential rationale?

Overall, in order for banks to have time to adapt to the new standards – in respect to both the impact on capitalisation and the organisational challenges - we recommend adopting appropriate phase-in arrangements, not limited in scope to those provided in the Basel III standards for the output floor.

6.4 Other Provisions

Question 185. In your view, which other aspects, if any, should be considered in the context of implementing the OF?

Please elaborate and rank your answers from the most important to the least important aspect.

One of the primary objectives of the output floor is to mitigate perceived variability in internal modelling. Firstly, we believe that more attention should be devoted to understanding the extent to which the results of IRB models deviate from actual losses (expected versus actual). Indeed, an EBA and a BIS study broadly confirm that 1) variance in prospective losses in IRB are mainly determined by actual differences in quality of portfolios 2) IRB models have tended to be conservative rather than optimistic in their outputs.

With these considerations in mind, we are strongly supportive of ongoing efforts to ensure quality of internal models and would point to the ECB's TRIM exercise in this respect. In our view, the focus should be placed here rather than on the introduction of output/input floors which will increase the divergence between realistic losses and the implicit reserves required. At the very least, these studies reinforce the Industry's call for a future output floor to be limited to the internationally applicable Basel capital requirements.

8. Sustainable Finance

Issue: In the context of the last CRR/D review, co-legislators reflected on the Paris Agreement on climate change and its impact on prudential regulation and agreed on three actions dedicated to sustainable finance:

- a mandate for the EBA to assess the inclusion of environmental, social and governance (ESG) risks in the supervisory review and evaluation process (SREP) and submit a report on its findings to the Commission, the European Parliament and to the Council; on the basis of the outcome of its report, the EBA may, if appropriate, issue guidelines regarding the uniform inclusion of ESG risks in the SREP (Article 98(8) CRD);
- a requirement for large, listed institutions to disclose ESG risks, including physical risks and transition risks (Article 449a CRR);
- a mandate for the EBA to assess on the basis of available data and the findings of the Commission High-Level Expert Group on Sustainable Finance, whether a dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives would be justified (Article 501c CRR).

Further to this work, the Commission has launched a [study on the development of tools and mechanisms for the integration of ESG risks into institutions' risk management, business strategies and investment policies as well as into prudential supervision](#). Final results of this study are expected for beginning of 2021.

As part of its [Action Plan on Sustainable Finance](#), the Commission proposed a [regulation for a framework for the establishment of an EU classification of environmentally sustainable economic activities \(so-called "EU](#)

taxonomy”) (COM(2018)353final- 24.05.2018). In parallel, the Commission set up a [technical expert group on sustainable finance \(TEG\)](#) that was tasked to already advice on a taxonomy for climate change mitigation and adaptation. While the negotiations on the legislative proposal are still ongoing, the [TEG has in the meantime published its report](#).

Question 191. In your view, which further measures, if any, could be taken to incorporate ESG risks into prudential regulation without pre-empting ongoing work as set out above?

Please elaborate and provide relevant evidence to substantiate your view.

Since 2015, the EMF-ECBC has been leading the [Energy Efficient Mortgages Initiative \(EEMI\)](#). The EEMI is a market-led initiative focussed on the design and delivery of an “energy efficient mortgage”, which is intended to incentivise and channel private capital into energy efficiency investments. The EEMI reflects the strong commitment of the mortgage industry to support a clean energy transition and to foster sustainable growth to the benefit of all. At the time of writing, 51 lending institutions, which represented 55% of mortgages outstanding in the European Union equal to 25% of EU GDP at the end of 2018, have signed up to the EEMI Pilot Scheme.

Pilot banks are supported by national market hubs and an Advisory Council comprised of 17 regional, national, European and international institutions or organisations. The development and rollout of EEM products are further supported by the conclusion of a common definition. The publication of the EEMI definition in December 2018 was extremely timely as it coincided with the launch of the EU Commission’s sustainability taxonomy, which now reflects the thresholds in the definition. Although narrower in scope, the EEMI is a concrete response to the policy goals of the European Union to integrate sustainability considerations into its financial system and avoid “green-washing”.

At the heart of the Initiative is the assumption that energy efficiency has a risk mitigation effect for banks as a result of its impact on a borrower’s ability to service their loan and on the value of the property. This means that energy efficient mortgages could represent a lower risk on the balance sheet of banks. Where a lower risk can be demonstrated we believe this should be reflected in better capital treatment.

In this respect, existing literature already points to a correlation between building energy performance and increased property value and lower probability of default. The innovation brought by the EEMI is to conduct analysis on banks’ current loan books and to enable banks to track performance over time. With regard to the latter, the EEMI is designing a data protocol and portal to collect and access large-scale empirical evidence relating to energy efficient mortgage assets allowing a comprehensive analysis of de-risking energy efficient features.

Early research conducted under the EEMI confirms the correlation between building energy performance and lower credit risk but also points to the fact that, at the same time, a correlation cannot be concluded only by looking at one-time snapshots of narrowly defined market segments. As such, this preliminary analysis laid the foundations for additional research and, at the time of writing, more in-depth and extensive analysis of the loan portfolios of European banks is being conducted.