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

Final Position paper on Implementation of Basel III Framework into EU Legislation

19 April 2021

The European Mortgage Federation-European Covered Bond Council (EMF-ECBC) is pleased to provide herewith its views on the forthcoming implementation of the Basel III Framework into EU legislation. This paper focuses specifically on the revisions to the Standardised (SA) and Internal-ratings based (IRB) Approaches for Credit Risk from the perspective of the mortgage lending business. It therefore is intended as a complement to our Position Papers on the Implementation of the Output Floor.

To briefly recall our position on the output floor, it is our assessment that the calculation of the output floor must be restricted to the capital components listed by the Basel Accord, i.e. exclude buffer requirements for other systemically important institutions, for systemic risk and for Pillar 2. Otherwise, the output floor would not act as a backstop affecting only outlier banks as intended by the Basel Committee. 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, alongside the risk-based requirement applying RWA calculated using approved internal models and standardised approaches as applicable and the leverage ratio requirement. All three capital requirements should be assessed. The most 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.

The EMF-ECBC would like to take this opportunity to recall the fundamental importance of EU mortgage markets to the EU economy. At the end of 2019, the volume of outstanding mortgage loans in the EU amounted to almost €8 trillion, equal to almost 50% of EU GDP. In addition to being a fundamental driver of the real economy as these numbers show, the mortgage lending business also provides access to housing finance for the EU’s citizens and funding to the EU’s businesses, highlighting the importance of a well-calibrated implementation of the Basel III Reforms.

The COVID-19 pandemic only serves to underline this approach and should give rise to an even more careful reflection on how the Basel III Framework is implemented in EU legislation, so as not to jeopardise the longer-term European recovery from the crisis.

Indeed, banks and capital markets will be fundamental to the economic recovery, by continuing to channel funds to businesses and households. Caution therefore should be exercised in implementing the output floor so as to avoid unjustified increases in capital requirements and limiting banks’ lending activities. This is all the more relevant in a context where banks will inevitably be impacted by the financial difficulties experienced by their most vulnerable borrowers and the increased volatility in financial markets.

Last but not least, the financial sector has been recognised as being fundamental to the transition to a climate-neutral economy. In this context, the mortgage industry in particular has the potential to play a transformative role as a catalyst for the development of an ecosystem comprising a broad spectrum of stakeholders, including consumers and SMEs, which can support financial stability and the attainment of the 2050 emission targets, in line with the EU Green Deal and the Renovation Wave Strategy.

Against this background, the Energy Efficient Mortgages Initiative, led by the EMF-ECBC, is designing a new, integrated, multi-stakeholder ecosystem focussed on the development of a market in energy efficient mortgages. With the EU’s...
households and SMEs at its heart, the Initiative is intended to deliver the capabilities to support the financing of the renovation of the EU’s building stock, 35% of which is over 50 years old and almost 75% of which is energy inefficient.

A careful and risk-sensitive calibration of the implementation of the final Basel III rules, including the output floor, is therefore of paramount importance to enable the mortgage industry to assume this transformative role to which it is committed to its fullest capacity.

**Executive Summary**

1. We welcome the introduction in the Final Basel Framework (paragraph 62) of the possibility for “modifications made to the property that unequivocally increase its value”...to also... “be considered in the LTV”. This is a very positive outcome, specifically from the perspective of the Energy Efficient Mortgages Initiative, which the EMF-ECBC is leading on, and responds to the European Commission’s efforts to stimulate sustainable finance in the EU. We therefore strongly advocate for the inclusion of this principle in the European implementation of the Final Framework.

2. The ‘valuation at origination’ principle is disproportionately penalising, particularly when the EU residential mortgage market is compared against the markets of other global jurisdictions. If LTVs are to be the key determinant of risk weights, they should be accurate, meaning they should be based on both a relatively current value and the current debt outstanding.

3. 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. Therefore 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.

4. In terms of the loan-splitting versus the whole loan approach, we strongly believe that each bank should be permitted to apply for the approach which most appropriately reflects their specific circumstances and environment in which they operate. Indeed, the impact of the each on RWAs depends on the specific mortgage model and a jurisdictions' mortgage lending traditions.

5. The EMF-ECBC acknowledges the revisions to the standardised approach for residential real estate exposures which is based on a higher level of risk sensitivity and provides more granular risk weights. However, in light of the low loss rates in this sector and the dual recourse nature of mortgage loans in the EU, the EMF-ECBC believes that a lowering of risk weights is justified. Further refinement to the loan splitting approach is also needed as the loan splitting approach as proposed in the Basel III standard completely ignores any effect of the residential estate collateral above LTV 55%. A specific refinement is to reduce the risk weight in the 55-80% LTV band based on the risk weight of the counterparty reduced by a factor of 25% to reflect that the loan is fully secured by the real estate property.

6. With respect to commercial real estate lending, the EMF-ECBC is very concerned that the new approach will be more detrimental to this exposure class compared to the former regime. There should be room for calibration of lower and more granular risk weights buckets are needed for commercial real estate and for income producing commercial real estate. At a minimum, the 0.3% ‘hard test’ approach in the Art. 126(3) CRR should be maintained for banks to be able to benefit from lower risk weights where justified by actual loss data.

7. We recommend an appropriate treatment of land Acquisition, Development and Construction (ADC) exposures in order to avoid penalising the financing of new housing and commercial buildings. We propose that exposures are classified as ADC exposures only when there are insufficient other income and assets of the obligor for mitigating the risk of losses (for instance, when the source of payment of loans depends mainly on the cash flow generated by the real estate that is being financed). In the other cases, exposures should be considered as SME, retail or corporate, with risk weights depending on the creditworthiness of the counterparties.
8. The Covered Bond Directive (and amendments to Art. 129 CRR), which entered into force at the beginning of 2020 and is to be applied from mid-2022, should be the reference points for covered bonds in the CRR in the Basel III implementation.

9. PD and LGD input floors for real estate under the IRB approach will result in significantly higher capital costs. 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.
I. Standardised Approach for Credit Risk: Real Estate Exposure Class

General Principles

- Eligibility of property under construction

10. We welcome the recognition of property under construction as residential real estate, but we consider the criteria listed in paragraph 60 of the Basel text to be excessively 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.

11. Furthermore, the current CRR rules (risk weight of 35%) do not limit 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.

- Possibility to update ‘V’ in LTV

12. We welcome the introduction in the Basel Framework (paragraph 62) of the possibility for “modifications made to the property that unequivocally increase its value”…to also...“be considered in the LTV”. This is a very positive outcome, specifically from the perspective of the Energy Efficient Mortgages Initiative, which the EMF-ECBC is leading on, and responds to the European Commission’s efforts to stimulate sustainable finance in the EU. We therefore strongly advocate for the inclusion of this principle in the European implementation of the Final Framework.

13. 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.

14. Indeed, as a response to this commitment, the EMF-ECBC, together with its EEMI consortium partners, has undertaken an analysis of the correlation between building energy performance and credit risk in relation to approximately 73,000 Italian mortgage contracts and has identified a statistically significant negative correlation, across all energy classes². This correlation has been further confirmed by recent analysis conducted by Nationwide in the UK, using the EEMI methodology, into 650,000 mortgage contracts³.

- ‘Value at origination’ vs. current value

15. 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:

16. 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.

17. An additional consequence that would arise from the capping of the property 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)/renovation. 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.

18. 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.

19. 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.

20. 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.

21. As a final consideration here, it is worth highlighting that in its policy advice to the European Commission on the Basel Reforms, the European Banking Authority (EBA) recommends allowing an increase in the value beyond the value at origination in line with Article 208 of the current CRR on the grounds that “fixing a collateral value at origination for 20 to 25 years (which is the usual maturity of mortgage loans in some countries) does not appear to adequately reflect the risks of the institution over the life of the loan”. The EBA suggests that their proposed approach “is considered to more accurately reflect the actual risk of the loan, while constant monitoring ensures prudent valuation”.

22. 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.

23. 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

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4 Policy Advice on Basel III reforms -Credit Risk.pdf (europa.eu)
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.

24. 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.

25. 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 (commercial and residential), (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.

26. 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 commercial or residential real estate in order to ensure that valuations are based on proven standards and implemented by qualified valuers based on a long-term data basis.

- Use of advanced statistical valuation models

27. On a final note in respect of property valuation, increasingly, advanced statistical valuation models are widely used and relevant in the context of the valuation of residential real estate (RRE). Against this background and in order to maintain efficiency of valuation processes, 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 where: (i) advanced statistical models are operated under the responsibility of qualified valuers, (ii) the quality of the models is assessed and validated, including the input data which should be appropriate and sufficient and supervised and back tested on a regular basis, and (iii) there is oversight of these models.

28. Indeed, it is important that regulators move in a direction that supports smarter and more automated valuations in situations where residential real estate markets are well established. The use of advanced statistical valuation models (not indexation) and registered data is increasing, creating more reliable data. It therefore makes sense for such models, where the conditions above are met, to be put on the same footing as manual valuations and for them to be considered as stand-alone valuation mechanisms, as is already the case in certain jurisdictions.
Exposures secured by real estate

- Loan splitting vs. whole loan approach

29. 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.

30. However, from a risk sensitivity perspective, the loan splitting approach as proposed in the Basel standard 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.

31. 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 depends on the specific mortgage model and, as there are different mortgage business models with historic mortgage lending traditions, we strongly believe that each bank should be permitted to apply for the approach which most appropriately reflects their specific circumstances and environment in which they operate. As a result of these specific circumstances, we do not see a significant regulatory arbitrage risk if both approaches were to be implemented.

- Risk Weights for Real Estate Exposures

Residential real estate

32. Overall, the revisions to the standardised approach present a mixed picture from a mortgage lending perspective. We acknowledge the revisions to the treatment of residential real estate exposures which result in 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.

33. 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.

34. 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 [25%] 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 [50%] in the 55-80% LTV band. This would imply approximately the same overall risk weight for an 80% LTV mortgage loan under the whole loan and the loan splitting approaches. 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.

35. 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.

Commercial real estate

36. 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 ≤ 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 ≤ 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 ≤ 55%).

37. 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.”

Income Producing Real Estate

38. 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 (CFRE) 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 (CFTotal). The repayment of a loan would be materially dependent on cash flows of the financed property if more than 50% of CFTotal is generated by the financed property (CFRE).

39. The treatment described here 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.

ADC Exposures

40. We recommend an appropriate treatment of land Acquisition, Development and Construction (ADC) exposures in order to avoid penalising the financing of new housing and commercial buildings. We propose that exposures are classified as ADC exposures only when there are insufficient other income and assets of the obligor for mitigating the risk of losses (for instance, when the source of payment of loans depends mainly on the cash flow generated by the real estate that is being financed). In the other cases, exposures should be considered as SME, retail or corporate, with risk weights depending on the creditworthiness of the counterparties.

41. It is also important to clarify a narrow definition of high-risk ADC exposures that will be associated with a 150% RW. Indeed, a too wide definition of high-risk ADC exposures would not capture the risks of this kind of exposures with an adequate level of risk-sensitivity. As mentioned in paragraph 75 and in footnote 52 of the revised Basel framework, when pre-sale or pre-lease contracts amount to a significant portion of total contracts (e.g. upper than 30% for residential assets), ADC exposures shall not be identified as high-risk exposures.

42. Furthermore, we believe that more risk sensitivity should be sought for the treatment of ADC exposures under the standardised approach, given the importance of such exposures for the real economy. In this regard, we propose that
banks under the standardised approach should have the option to use the slotting approach (subject to supervisory approval), which is currently available for banks using the IRB Approach in the context of specialised lending. This would make the treatment of ADC exposures more risk sensitive, rather than assign a uniform risk weight of 150% that does not reflect actual risks.

**Other Issues: Covered Bonds**

43. 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. The harmonised European framework for covered bonds (the Covered Bond Directive and amendments to Art. 129 CRR), which entered into force at the beginning of 2020 and is to be applied from mid-2022, should be the reference points for covered bonds in the CRR in the Basel III implementation.

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

45. 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.

II. Internal-ratings based (IRB) approaches for credit risk

> **Real Estate Exposures**

46. 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.

47. With regard to advanced IRB approach (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.

48. 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 necessitates 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**
49. 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 foundation 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. 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.