Comments[1]

on the EBA consultation paper on RTS on conditions for capital requirements for mortgage exposures (EBA/CP/2015/12)

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

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[1] Please note that these comments are subject to the final approval by the committees of the Association of German Public Banks (VÖB).

Comments on the EBA consultation paper on RTS on conditions for capital requirements for mortgage exposures (EBA/CP/2015/12)

On 6 July 2015, the European Banking Authority (EBA) published the Consultation Paper "Draft Regulatory Technical Standards on the conditions that competent authorities shall take into account when determining higher risk-weights, in particular the term of "financial stability considerations" under Article 124(4)(b) CRR and the conditions that competent authorities shall take into account when determining higher minimum LGD values under Article 164(6) CRR". We gladly take the opportunity to express our opinion.

I. General remarks

To maintain a level playing field, it is of considerable importance to the institutions in the Eurozone that any increase of the risk-weights in the standardised approach or of the LGD floors in the internal ratings based approach, which may be necessary in the view of the supervisory authorities, will take place on the basis of uniform standards in the Eurozone member states. In our opinion, this also is the intention expressed in Article 124(5) CRR. We, therefore, welcome that the conditions for the definition of higher risk-weights or higher LGD floors are to be assessed at regular intervals by the competent authorities on the basis of the state of the national immovable property market.

We understand that the EBA's proposals regarding the increase of risk-weights would concern those institutions that apply the standardised approach for credit risk. The proposals regarding the increase of the minimum LGD values would concern institutions that apply the IRBA and estimate own LGDs for retail exposures in accordance with Article 143 CRR. In this respect, the provisions of the Consultation Paper would in the case of IRBA institutions not come into consideration for the treatment of exposures to companies which are secured by real estate. In particular, we assume that the use in the basic IRBA of LGDs defined by the supervisory authorities in accordance with Articles 230(1) and (2) CRR will not be restricted and the use of the alternative risk-weight in accordance with Article 230(3) CRR can be continued also with higher risk-weights. We ask to include a clarification in the draft standard.

Furthermore, in the interest of uniform capital requirements on a national immovable property market, the following principle problem should be resolved by all means:

According to Article 124(2) Sentence 1 CRR, the "competent authorities" assess at regular intervals whether the aforementioned increases are necessary. There is no doubt here that for the SSM institutions of the Eurozone the competent authority within the meaning of that sentence of the CRR is the European Central Bank (ECB), while the respective national authority is competent for the increase decision regarding the LSIs. The methodological approach described in the RTS for carrying out this regular examination and for making a decision on that basis rightly leaves a wider margin for the competent authorities to make the assessment or decision. This margin which, on the one hand, is necessary due to the national peculiarities of the immovable property markets, on the other, makes it appear not unlikely that for example the assessments made by the ECB and the BaFin for the German immovable property market (or for subsegments thereof) will be different. Even if both authorities believe that an increase of the capital requirements is reasonable, the extent of the increase they decide on will not necessarily be identical. This would lead to different capital requirements for identical exposures, and hence identical risks, within the respective immovable property markets of the Eurozone. This should be avoided by all means.

Moreover, resultant problems occur. For example, how should a French SSM institution/LSI treat German exposures according to Article 124(5) CRR? Based on the ECB's or the BaFin's capital requirement specifications? The contradiction between Article 124(2) Sentence 1 and Article 124(5) CRR should by all means be resolved consensually between the national supervisory authorities and the ECB. In addition, it

should be clarified how the problem can be solved if a consensual solution cannot be found. The macroprudential considerations regarding financial stability included in the methodology of an increase of the capital requirements should be assessed with due regard to the further regulatory options or already implemented measures of the ESRM or the national "committees for financial stability". For example, it is expected to be possible in Germany from 2016 on to define minimum requirements for the financing of residential property (minimum amount of equity to be used in the financing, minimum repayments) to limit over-indebtedness risks and to limit price bubbles. Measures to define anticyclic capital buffers ultimately also follow macroprudential considerations. With respect to this, it has to be ensured that these measures are consistent with each other and that the measures are not excessive with regard to an overall impact assessment. Moreover, it has to be pointed out that apart from the instruments according to Articles 124(2) and 164(5) CRR there also are the measures according to Article 458(2)(c) CRR which can be applied alternatively.

According to Article 193(1) CRR, no exposure for which an institution has achieved a credit risk mitigation must receive a higher risk-weighted position amount than an exposure for which a credit risk mitigation is not available but which is otherwise identical. Even though Article 193 CRR cannot be applied directly to Article 124 CRR, it should nevertheless be used as a guideline for all decisions of the competent authorities. It should not be possible that the increased capital requirements for fully secured exposures can exceed those for corresponding unsecured exposures (cap), as this would create dangerous wrong incentives to not secure risks in order to reduce capital requirements.

The RTS makes it possible to define increased capital requirements not for the entire national immovable property market but just for certain subsegments. For example, the RTS mentions regional segments. The competent authorities should by all means make use of this differentiated possibility.

However, we are critical of the strict application of "mandatory reciprocity". In our opinion, this obligates institutions to apply the higher risk-weights applying abroad irrespective of the actual significance of a possible real estate financing in a foreign country. For institutions that have provided just a few real estate financings in a country, this would result in substantial additional expenditure for the calculation of the equity capital securitisation that would not be in proportion to the loans granted. We, therefore, suggest the introduction of a lump sum analogous to the anticyclic capital buffer below which the risk-weight or the minimum LGD of the country of incorporation may be applied.

II. Special remarks

Q1: Do you agree with the three main categories of conditions specified for the setting of higher risk-weights (paragraph 1) and the setting of higher minimum LGD values (paragraph 2)?

The three main categories (loss experience, forward-looking market developments, financial stability considerations) under which higher risk-weights or higher LGD floors may be imposed result from Article 124(2) and Article 164(5) CRR. Insofar, the draft RTS follows the CRR specifications. However, what is of crucial importance is the methodology applied to initiate a prudential assessment of the appropriateness of the capital requirements on the basis of the joint analysis of the three main categories mentioned.

As we understand the CRR specifications, loss experience is the starting point and hence the basis of the analysis. And this makes sense. As this is experience gathered in the past, it is necessary to make quantitative adjustments for anticipated market price and volatility trends on the basis of historical values where market expectations are deviating. Increased loss expectations for the adjusted historical values

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should be a necessary precondition to get to increased risk-weights or increased LGD floors. Financial stability considerations should come into play only if increased loss expectations exist as a necessary precondition. The capital requirements assessment process should be initiated only when these considerations as well show systemic risks which are not already reflected in the adjusted loss expectations.

We welcome a possible wide analysis basis provided by the "other conditions" which can cover numerous national conditions.

Q2: Do you agree with the conditions for specification of the loss experience and the loss expectations? Do you agree with the adjustments allowed to be made to the loss experience on the basis of the forward-looking immovable property market developments?

We basically find that recourse to the data of the surveys pursuant to Article 101 CRR is reasonable to determine the loss experience. With that, a uniform data basis is applied and the traceability of the results is strengthened. However, the CRR purposely does not directly link the loss experience values to the privileged risk-weighting.

With respect to the adjustments of the loss experience to anticipated market developments, Article 2(2) of the draft RTS mentions substantial influencing factors for adjustment. Such forecasts – in particular if they include forecast horizons for the fulfilment of the expectations - are highly complex. It is important to state first that the market expectations need not necessarily result in the loss experience having to be adjusted upward. It must still be possible in principle to expect lower losses than predicted by the historical data. We are critical of the adjustment of the loss experience also because as far as we know the supervisory authorities as well have no experience with the handling of such a procedure. We, therefore, suggest that the competent supervisory authority create and consult its own procedure for deriving loss expectation from loss experience based on the influencing factors mentioned in Article 2(2) of the draft RTS.

Moreover, it appears to be unclear whether the EBA has intended that only a selection of criteria needs to be fulfilled for the risk-weights in the standardised approach to be appropriate (Article 2(2) of the draft RTS: "such adjustments shall be based on any of the following"), while all criteria need to be fulfilled for the minimum LGD values to be appropriate (Article 5(2) of the draft RTS: "such adjustments shall be based on all of the following"). We ask to clarify this.

In our opinion, the criteria mentioned for the assessment of the appropriateness of risk-weights and LGD floors give the competent authorities in the EU Member States a very wide scope of discretion. The definition of further conditions in Article 4 and Article 6 of the draft RTS, which are to be taken into account in addition if the risk-weights or the LGD floors are to be increased, even further widen the authorities' scope of discretion. Our experience is that forward projection and assessment of real estate market prices and volatilities often causes difficulties. To enable the prediction of future trends with a higher degree of certainty, we believe it is necessary to determine the strived-for level playing field for the competent authorities within the Eurozone in more detail by means of test criteria. We see a danger that more favourable competitive conditions for the financing of real estate investments can be created arbitrarily within the EU Member States.

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Q3: Do you agree with the indicative benchmarks for the assessment of the appropriateness of the risk weights and to guide the setting of higher risk weights across immovable property markets in different member states as specified in Article 4(3) and 4(4)? What levels of these indicative benchmarks would be most appropriate and why?

We generally support the use of benchmarks, as long as they bare an indicative character and as long as there is now an automatic increase in risk weights if the limit is exceeded. A breach of the benchmark should only trigger a screening process without a predetermined conclusion.

We propose to take the initial risk weights of 35% or 50% as starting point and base the calibration on the level of loss expectations for setting higher risk weights that takes into account these initial risk weights.

As a matter of fact the maximum risk weight of 1250% used in the CRR is calibrated to cover a loss up to 100% of the exposure value. Therefore, a risk weight of 100% serves for covering up to 8% losses, thus the risk weights of 35% and 50% serve for covering losses up to 2.8% or 4% respectively.

We therefore believe that the level for the indicative benchmarks for increasing risk weights has to be significantly higher than the proposed 0.3%. The level of 0.3% mentioned in the consultation paper (see also point 5.1, page 24) is referring to the benchmark taken into account for the so called “hard test” for the preferential risk weights for residential and commercial real estate according to Article 125(3)(b) CRR and Article 126(3)(b) CRR. The aim of this benchmark has to be distincted from the target of the RTS.

This suggestion implies that in general the average loss implied by the initial preferential risk weights of 35% and 50% is the “normal” level to which the average losses reported under Article 101 CRR need to be compared. Given the 2.8% or 4% maximum loss coverage, the initial risk weights of 35% and 50% can be understood as in general sufficient for an average loss expectation of 1.4% or 2%, respectively.

By this means loss levels and risk weights would be combined: A level of losses of 2% is observed or expected for the portfolio of exposures secured by residential real estate. The level of 1.4% is exceeded, and therefore the risk weight of 35% may be increased by a ratio of 2% /1.4% (= 143%), which leads to a new risk weight of approximately 50%.

The value of 1.4% should therefore be inserted in point (a) of Article 2(4) and point (a) of Article 4(3), and the value of 2% should be inserted in point (b) of Article 2(4) and point (a) of Article 4(4) of the RTS. In addition this should also be reflected within the specification of the intervals.

The higher risk weight should in any case only be applied if this is deemed necessary under financial stability considerations.

Q4: Do you agree with the specification of the term of "financial stability considerations"?

We find that the considerations regarding the assessment of the financial stability are not specific enough. They build on (spill-over) effects on the resilience of the financial system or the lending activity which could result from SIFIs or other banks being impacted when higher loss rates occur. We consider it critical that the fact of SIFIs being impacted might also lead to higher requirements on many small institutions although they may serve other areas of the immovable property market.

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The competent authorities have a wide scope of discretion here that we believe is appropriate. We doubt whether it is reasonable to impose higher capital requirements out of financial stability considerations when disturbances of the lending process are observed. This will normally be counterproductive and should, therefore, not be further pursued as a criterion.

Q5: Do you agree with the other conditions for the setting of higher risk-weights? (Please provide your feedback related to the indicative benchmarks (in Article 3(3) and 3(4)) in your response to Question 3 above.)

We refer to our comments on the questions Q2 and Q3.

Q6: Do you agree with the conditions for specification of the exposure weighted average LGD and the LGD expectation? Do you agree with the adjustments allowed to be made to the average exposure weighted LGD on the basis of the forward-looking immovable property market developments? Do you agree that it is not appropriate to set indicative benchmarks for the setting of higher minimum LGD values because of the specificities of national immovable property markets and because of the relationship of the LGD parameter with the other internal model parameters?

As already explained for the standardised approach risk-weights we basically believe it is proper that adjustments shall be possible also with respect to the minimum LGD. However, clearly increased adjusted LGD average estimates should be available first before higher floor requirements are imposed.

We support the view that there shall be no indicative benchmarks. This enables more flexible handling and also takes account of the existing relationship of the LGD parameters with other IRB parameters, in particular the PD, and the very specific national conditions.

On the other hand, we believe the scope of discretion of the respective competent authorities of the EU Member States is too wide as regards the potential increase of the floor because it is not limited. In our opinion, it is necessary here as well to determine the strived-for level playing field for the competent authorities of the EU Member States in more detail by means of test criteria. A cap for the LGD floor increase should be defined (max. 100% increase).

Q7: Do you agree with the other conditions for the setting of higher minimum LGD values

We refer to our comments on the question Q6.

Q8: Do you have any suggestions on the Impact Assessment?

n/a