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BANKING STAKEHOLDER GROUP

CONSULTATION ON EBA/CP/2015/12 ON
DRAFT REGULATORY TECHNICAL STANDARDS ON CONDITIONS THAT COMPETENT AUTHORITIES SHALL TAKE INTO ACCOUNT WHEN DETERMINING HIGHER RISK WEIGHTS, IN PARTICULAR THE TERM OF "FINANCIAL STABILTY" CONSIDERATIOS, AND THE CONDITIONS THAT COMPETENT AUTHORITIES SHALL TAKE INTO ACCOUNT WHEN DETERMINING HIGHER MINIMUM LGD VALUES UNDER ARTICLE 164(16)CRR

General Comments and Replies to Questions

BY THE EBA BANKING STAKEHOLDER GROUP

London, 1st October, 2015

General comments

The BSG welcomes the opportunity to comment on the Consultation Paper EBA/CP/2015/12 (draft RTS). As in the past, the BSG supports any initiative that aims at harmonizing supervisory rules and practices across Europe, in order to ensure fair conditions of competition between institutions and more efficiency for cross-border groups.

Nevertheless, we express some general concerns that we urge the EBA to take into account.

- Conditions: scope and specifications.
  Institutions are in dire need of **transparency and predictability** in the use of supervisory tools impacting capital ratios. Otherwise, the intended harmonization of supervisory practices might not be reached. Although, the draft RTS lists a set of conditions, these are too limited and not sufficiently specific. Therefore, more clarification is needed. The BSG would expect a **description of a clear and comprehensive set of financial stability indicators** on which competent authorities will base their assessment of the appropriateness of actual risk weights or LGDs. Moreover, the **relation between those indicators and financial stability** needs to be explained in order to fully understand how competent authorities look at the housing and credit market.

- Purpose: short term versus long term.
  Also, it is not clear if the proposed actions are designed to handle **short term fluctuations**, rather than more lasting **structural evolutions** in the economy. The second objective seems more appropriate for the RTS, as there are already macro prudential tools available to the regulator to handle more short term concerns, e.g. the Countercyclical Capital Buffer. Although we do recognize that these macro prudential tools target the lending activity as a whole, rather than individual segments or portfolios, **too much volatility in risk weights** should be avoided as much as possible.

- Temporal character.
  Also, it would be welcomed if the RTS could describe when, once used, the tools will be considered successful and under what conditions and **timing their use could be reversed.** In this vein, the annual analysis must be rigorous enough in order to modify the measures previously taken.

- Possible negative impact.

The BSG is concerned that the actions as proposed could push institutions towards riskier segments of the market, certainly when accompanied by strong capital ratios, or could perversely punish institutions with strong qualitative portfolios and well-adapted credit policies. This would apply to, for instance, institutions, with large percentages of exposure regarded as fully secured, or with low LGD-values in the case of IRB-institutions. The RTS thus risk at **impacting institutions with low risk lending practices** proportionally heavier than necessary.

BSG therefore suggests introducing **a multiplier factor**, when financial stability considerations force competent authorities to set higher minimum LGD. This factor should multiply the actual LGDs, thereby safeguarding the direct link with the structural differences in portfolio quality and the applied credit policies in general.

- Consistency and integration.
  As a final general remark, the BGS is concerned about the **consistency** in the use, impact and timing between all possible tools of competent authorities under the diverse regulations and legislations, to enhance financial stability.

Replies to Questions

Question 1:
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)?

Response:
Art. 124, 4. (b) and 164, 5. CRR asks competent authorities to assess whether the risk weights and minimum LGD values are appropriate. When considered too low **on the basis of financial stability considerations**, the risk weights and the minimum LGD may be raised. We see no added value specifying three categories of conditions. Indeed, it is difficult to distinguish the impact from separate conditions in the overall evaluation and decision to increase risk weights and LGD.

In fact, “ financial stability” and its relation with the immovable property market is the essence of what CRR wants the RTS to draft. Therefore, we would expect

the RTS to propose and explain a set of indicators on drivers of that market, possibly causing financial instability. Although art.2 and 5. of the draft RTS sum up a number of indicative elements, they do so in rather **vague wording** and obviously too much focussed solely on price evolutions in the property market.

See also our comment under question 6.

Question 2:
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?

Response:

The BSG do not have any strong feelings against the conditions for specification of the loss experience and the loss expectation, or the adjustments allowed to be made on the basis of the stated forward-looking developments. However, and this ties in to our response to question 3, the RTS consistently mentions historical and forward looking estimates, but leaves the time horizon unspecified. It is our opinion that the time horizon will be of significant importance for both the required analysis and the final national application of the regulation. A minimum time horizon for the materialization of losses or developments would help make the future application of the RTS more consistent and transparent. In this respect it also seems counter intuitive that the authority of the NCA in accordance to article 2(3) would in effect be larger the less information that is known, or the less certain they are with regards to their analysis. In this case the NCA analysis should at the very least conclude potentially severe development, or the degree of discretion in the interpretation of the article would be too wide. As it stands, the current formulation opens up for a prudent NCA to increase the risk weights in situations where this might not be appropriate.

See also our response to question 6.

Question 3:
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?

Response:

See also our response to 6.

The use of a benchmark has the important advantage of being simple and clear, conform the standardised approach. The need to have a design consistent with CRR should be out of discussion .Nevertheless, before using the benchmark it is necessary to clearly define, specify and harmonize the rules (as mentioned above in the general comments), if not the benchmark will not make sense.

The appropriateness of the indicative level of the benchmarks is proposed to depend on so called implied level of losses, deduced from two possible arguments within CRR and explained under 5.1 "accompanying documents" of the draft RTS. The BSG only considers the first given argument as convincing. Indeed, although the first argument is already grounded in important assumptions, the second argument is even more dependent on a larger set of assumptions.

It must be recalled that the RTS should clarify "financial stability considerations". It is dangerous to accept that the assumptions made, will still hold in times of perceived instability risks.

Therefore, the proposed benchmark, developed in the first argument, can be accepted, although its use should not be mechanic. Indeed, it should only be one of the (minor) elements in the judgement of the competent authority.

If the purpose of the regulation is to guard against **short term shocks**, it seems that the indicative benchmarks would be inappropriate for the purpose. As is mentioned in the "calibration" chapter under 5.1 of the draft RTS, the 35 % risk weight is supposed to cover losses up to 2.8 % or on average losses of 1.4 % given some assumptions. It is our opinion that in the short term the loss expectation for individual years, or even shorter time periods, must be allowed to reach levels higher than 1.5 %, the level withhold in the draft RTS. After all, short term fluctuations do not influence the long term average losses. As the draft RTS does not mention the time horizon or length of the forward looking macro-economic assessment nor the time period during which these loss expectation are supposed to be valid, the mentioned benchmarks seem at risk of **creating undue volatility** in risk weights, as well as a high degree of national discretion in the interpretation of the RTS.

Additionally, the benchmark only considers the minimum capital requirements, and it should take into account the additional buffers and Pillar II possible measures.

However, if the intent is to ensure that the risk weights serve as a prudent long term risk assessment of the exposures, which the BSG deem as a more

appropriate purpose, the indicative benchmarks makes sense, since the long term loss expectations apparently shifted, rendering the previous risk weights inappropriate. In these circumstances an increase in risk weights would be sound.

Finally, a reflexion is needed on the usefulness of a benchmark considering that there are so many differences in the real estate markets among EU Members States.

Question 4:
Do you agree with the specification of the term of "financial stability considerations"?

Response:
According to the CRR, financial stability considerations, regularly assessed, can give reason to increase the capital requirements related to mortgage lending.

The BSG would leave out art.3, since its content should be completely covered by art.2 and art.5. These articles, in fact, should clarify the "financial stability considerations". These considerations should form, as such, a single category and therefore should be completely integrated in art. 2 and 5.

Question 5:
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 4.3(3) and 4.3(4)) in your response to Question 3 above.)

Response:
We understand these "other conditions" to be an invitation to the competent authorities to be as transparent and explicit as possible about the reasoning behind the assessment of the financial stability considerations. As already stated in our introductory general remarks, the BSG very much welcomes this approach. However, we would be even more positive if the timing element would also be taken into consideration, by answering the questions **"why now?"** and **"for how long?"**

Question 6:
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?

Response:

See also our answer to question 4.

First, the proposal is **too much focussed on the market prices for immovable property**. This approach suggests LGD is mainly driven by price-evolutions on that market. This assumption should be questioned. Even more, the historical evolution in the immovable property market is not necessarily per se relevant for the determination of LGD expectation. It is also questionable to what extent the historical volatility of the immovable property market is relevant for the specification of the exposure weighted average LGD expectation.

It must be clear that expectations about LGD are influenced by several other factors, such as and not limited to:

- **activity** levels and evolutions in the property market;
- forward-looking assumptions on **defaults**;
- the actual economic situation, in order to correctly assess cure-rates and cash flows generated from **recoveries**;
- forward-looking **financial market** developments: e.g. evolutions in the mortgage market;
- levels and evolutions of the **indebtedness of households** in general (including unsecured lending) are not withhold in the draft RTS;
- the evolution of **household income.**

Next to the price evolutions in the property market, **price levels** are equally relevant.

In addition, and as a general remark, it is **important to act on qualitative data.** In our view, just the data quality on immovable market prices valuations is unequally guaranteed throughout all jurisdictions and institutions. Let alone the data quality of other possible indicators.

Second, “time horizon” is mentioned, but not specified. **Timing** of possible actions is of the utmost importance. Therefore, institutions would welcome more transparency on this subject.

Third, nothing is specified about possible **fine-tuning** of actions. Market problems can arise in certain sub sectors of the property market, be they be by

region or by type of property, or client segments. More possible differentiation would certainly be welcomed.

Next, in art.5, 2, (f) the draft RTS considers possible actions already taken by individual institutions and it does so correctly. However, possible actions to be considered should not be restricted to reductions in collateral value only. In the same art. under (d), indeed, debt-service-to-income is highlighted. Here again, the BSG warns against too optimistic expectations on data quality. Other possible **actions already taken by institutions** could include asset / liabilities management and funding activities. The BSG warns that a possible side-effect can be a reinforcement of the already started downturn in a segment of exposures. In addition, the increased requirement could affect institutions and regions which are beyond the identified increased risk or which hold a totally different risk profile.

Finally, to some extent, systemic risk and financial stability are the responsibility of multiple authorities and regulations. The consultation should include considerations related to other regulatory activities that in part or in total, are designated to mitigate the same area of risk but effect through other requirements. In this vein, the global impact and the interaction of these measures with other financial stability proposals in the CRR (such as the anti-cyclical buffer) and the real estate market (review of LTV, or limit the Total Debt Service Ratio (TDS) must be carefully analysed.

The BSG agree that indicative benchmarks are not appropriate.

Question 7:
Do you agree with the other conditions for the setting of higher minimum LGD values?

Response:
We understand these “other conditions” as an invitation to the competent authorities to be as transparent and explicit as possible on the reasoning behind the assessment of the financial stability considerations. As already stated in our introductory general remarks, the BSG very much welcomes this approach. However, we would be even more positive if the timing element would also be taken into consideration, again answering the question “why now?” and “for how long?”.

Question 8:
Do you have any suggestions on the Impact Assessment?

Response:
The BSG agrees with the discussion related to indicative benchmarks for setting higher LGD floors. There are too many uncertainties in building up these

benchmarks for a broader use. A direct objection to the use of benchmarks is the fact that different jurisdictions show non-comparable historical loss-data.

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Submitted on behalf of the EBA Banking Stakeholder Group

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