EBA 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

Key Points

Although the CRR foresees, under articles 124(4)(b) and 164(6), the possibility of adjusting the RW/LGD due to financial stability considerations, it is our opinion that within the current prudential framework there are best suitable tools to correctly address the mentioned risks underlying the immovable property market. It is the case of Pillar 2 measures or other specific inspections conducted by the supervisor, to assess the appropriateness of haircut methodologies and assumptions used by different banks.

Risk 1 – specificities of each bank's portfolio (*see annex 1 for further details*)

We highlight that the implementation of a common macroprudencial measure for all banks in the same jurisdiction could harm the specificities and assumptions made by different banks. One should not put aside that different banks have different credit processes, different risk profiles and different risk methodologies, and the definition of a constant and generic minimum LGD or RW value, without taking into consideration the idiosyncrasies of each bank, could penalise banks with more conservative credit standards.

Evidence shows the existence of significant differences in historical losses among banks in the same jurisdiction, which contradicts the potential benefits of any macroprudencial measure that defines the same minimum RW/LGD values, for all banks acting in the same jurisdiction.

As shown in "*EBA report on the range of practices regarding macroprudential policy measures*", published on July 2015, there are cases in which the application of articles 124(4)(b) and 164(6) isn´t the best solution, as it does not account for institution-specific characteristics, and should in fact be replaced through supervisory measures in accordance with Pillar 2.

Additionally, for the purpose of capital requirements calculation, and since Basel II, any bank is required to periodically assess the collateral value of its portfolio (for eligibility purposes) and include forward looking analysis under such assessment. The competent authority has the tools to validate those processes through specific inspections or under the normal validation procedure of Pillar 1 requirements.

Risk 2 – Procyclicality nature of the measure

We understand that the exercise of a macroprudencial measure of this nature will weight only in a context of a decrease of real estate prices. In fact, it is our opinion that due to the

correlation between real estate prices and historical loss experience, when real estate prices start to increase there is little foundation for applying such a measure.

However, in a context of a decline in real estate prices, the adoption of higher requirements will not solve the immovable property market problem but will in fact contribute for its escalation. As the cost of capital increases, this will be passed-through clients, with consequences in terms of delinquency, which will lead to new problems in the immovable property market. This will not contribute to the protection of the financial stability of the banking sector neither to the economic stability of the immovable property market.

In our opinion, if a significant decrease in real estate prices occurs, the competent authority should require more strict measures and assumptions for each bank according to the nature of its portfolio (through a SREP measure). By doing so, the effective risk would be mitigated and addressed in its roots, instead of being targeted through the use of a macroprudencial measure, that could inflate the problem and would not take into account each bank's specificities.

Annex 1

In the present annex, we provide some comments and examples to reflect our concerns regarding the adoption of measures under articles124(4)(b) and 164(6).

***1. Specification of Loss expectations** (articles 3(2), 3(3), 5(2) and 5(3))*

The proposal for the calculation of loss expectations on a forward looking approach includes two provision adjustments that are difficult to be implemented without compromising a level playing field within the same jurisdiction:

- LTV and DTI: Being the loan-to-value ratio (LTV) and debt service-to-income ratio (DTI) a reflexion of each bank's credit process (granting and monitoring), there is a high probability that those values differ across banks in the same jurisdiction. Thus, how can the competent authority take a unique decision about the RW/LGD for the overall national banking system, based on average market LTV and DTI figures, when those same figures in each bank could be very heterogeneous?
- Immovable property prices (haircuts): In a similar way, different banks, in the same jurisdiction, can have different forward looking methodologies for their collateral values. How can the competent authority take a unique decision about the RW/LGD for all the banking system, based on a forward looking estimated market haircut, when different banks use different haircut methodologies and forward looking assumptions (and consequently adjust their collateral values in different ways)?

***2. Indicative benchmarks** (articles 4(3), 4(4) and 6)*

The same arguments provided by EBA to support the exclusion of indicative benchmarks for an IRB approach are also valid for a Standard approach. Regardless of using a standardized approach or an IRB approach, the RW is a measure of the unexpected loss and the use of a standard RW or an IRB RW does not change the fact that an implicit PD and LGD exist for both situations.

Additionally, we cannot agree with the definition of indicative benchmarks for the assessment of the appropriateness of the risk weights, as it assumes that the local markets loss experience is aligned with each bank's exposures loss experience, which is far from the truth. In fact, there will be difficult to find a single bank, in a jurisdiction, that has equivalent loss levels as the ones obtained for all the banking system, in that same jurisdiction. As such, the definition of indicative benchmarks will substantially collide with each banks' specificities.

As mentioned in the consultation document, the proposed benchmarks assume the expected loss as the principal risk factor for RW definition. Regarding RRE, two buckets are defined:

  - bucket 1: EL between [1,5%-x%] for an RW between [35%-100[;

- bucket 2: EL>x% for an RW between [100%-150%].

If this relationship is assumed, it should not be made through the definition of just two unique buckets but through a continuous relationship between the EL and the RW. The definition of just two buckets for RW decision (one from 35% to 100% and another one from 100% and 150%) will give a high degree of discretion for the different competent authorities, which contradicts the level playing field defined as an objective by EBA. As it stands, the same EL in different countries could originate different RW (e.g. Country X with an EL = 1,6% sets a 40% RW and Country Y, with the same EL value, sets a 80% RW).