

6/10/2015

European Banking Authority

## **Conditions for capital requirements for mortgage exposures**

From a level playing field perspective it is essential that competent authorities makes as similar assessments as possible on the basis of CRR and that the same capital requirements are connected to the same level of risk throughout the EU. Based on the uniformity of the framework it is important that the criteria that the competent authority has to consider are as concrete as possible. When a forward-looking assessment should be made, it is essential that the criteria are clear and visible. We would especially draw the attention to this proposal not combining the conditions and the consequences that this may cause due to different implementations (ref. also ESRB handbook and single rule book). New standards should not further extend the supervisory practices or increase the competent authorities mandate or flexibility to set aside common rules. Increased use of supervisory judgements will lead to less harmonisation, and are often difficult for banks to anticipate in their capital planning.

We would also like to mention that supervisors have tools to impose a minimum level, for example, by virtue of Article 458 of the CRR they can increase risk weights for targeting asset bubbles in the residential property and commercial immovable property sector within the scope of macro-prudential oversight.

It is important that the main rule rely on banks' own LGD estimates, and not a supervisory practice that is based on general assessments or a biased risk weight level based on an external and non-quantifiable systemic risks. We fear a trend where competent authorities change banks risk sensitive models by imposing floors to all parameters based on general assessments anchored in external risk. Add-ons should primarily be based on quantifiable parameters, such as loss rate and model or matrices built on this. General add-ons or risk weights may decrease the supervisor's interest to monitor IRB models and it contradicts with the intention with internal rating based models. This is not ideal for banks risk management.



### **General comments on determining higher risk-weights**

According to proposed article 2.2 the loss expectation shall be determined by adjusting the loss experience to reflect forward-looking immovable property market developments. In order to promote consistency we are of the opinion that such adjustments shall be based on *all* of the criteria in article 2.2 (a-f) when the loss expectation is determined. When taking all of the criteria in to account will the basis for the determination be less volatile and less depended to a subjective judgement of one single criteria. The change (from any to all) is in consistency with the wording under the proposed article 5.2 "such adjustments shall be based on *all* of the following".

We support the proposal to have benchmarks to indicate what level of loss expectation is appropriate for setting higher risk weights. We believe the indicative benchmarks should be set as high as possible to reduce recurring deviations in risk weights from standards CRR levels.

We suggests there should be limits as to how large a rise might be at one point since an increase of the risk weight, both for residential and commercial real estate, might have a substantial impact on the capital requirements. Also, this is appropriate since the transitional period to apply a higher risk weight only is 6 months according to article 124.3 in CRR where the transitional period is 12 months when increasing the counter cyclical buffer.

A calculation example shows that for a bank with approx. 30 per cent of total assets in residential real estate with 35 per cent risk weight, a rise of risk weight with 10 per cent units to 45 per cent would result in a higher capital requirement increase than would an increase of the counter cyclical buffer with 0,50 per cent for the same bank. In order to prevent a higher increase in capital requirement to be implemented within shorter time frame (risk weight) than a lower with a longer time frame (buffer) it would be prudent to introduce a limitation as to how much the risk weight can be raised at one time.

### **General comments on determining higher LGD values**

From a level playing field perspective when a forward-looking assessment should be made, it is essential that the criteria are clear and concrete. It is our view that the draft RTS include too many unquantifiable justifications. The capital regime should not have models where the parameters to a large extent rely on general justifications and unquantifiable justifications. Changes in LGD (and risk weight) should primarily be subject to measurable quantities. All the three conditions should be considered and analysed, so that supervisors cannot choose to exclude two of the conditions.



To achieve this there should also in addition to the limits set for the standardised approach, be maximum limits introduced for LGD to achieve a homogeneity in the regulation.

Further, it is important to define the correct order of implementing measures due to financial stability reasons as well as to define if the requirement should be time varying. The term forward-looking should be further specified, e.g. which time horizon, should it be specified on certain segments, which indicators etc. Which scenarios are to be included, can some reference to banks stress scenarios be made, what is the relevant increase in property prices etc. Banks already make adjustments for changes in market values, which also affects the LGD.

The adjustments proposed to be made based on forward-looking criteria's and the financial stability considerations should be more concrete and specific. As the proposal stands it is not clear which exact considerations the competent authority should make and which impact respective consideration should have (article 5.2 (b) is unclear and 5.5 (a) could be taken out).

### **Answers to specific questions**

#### **Question 4: Do you agree with the specification of the term of “financial stability considerations”?**

In order to obtain more consistency in applying higher risk weights, the terms and definitions for article 2.2(e) should be made, e.g. structural and cyclical characteristics, and volatility. There might be set some thresholds related to volatility and cyclicity as guidance. In article 2.3, different levels of loss expectation in combination with risk weight/LGD could be further developed.

#### **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 3(3) and 3(4)) in your response to Question 3 above.)**

Other and non-quantifiable justifications should not be used to change risk weight or LGD, but should be used as arguments for increasing the system risk buffer or the countercyclical capital buffer. Non-quantifiable justifications will not increase consistency in risk weights and will gradually undermine the reliance of internal models and risk management incentives, which would be destructive for banks motivation for a sophisticated risk structure and methods for managing risks. Supervisory and high levels of parameters will lead focus away from e.g. focus on triggers for risk migration below the new risk weight/LGD levels and real risk drivers etc.



**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?**

*Article 5.2*

a) How far back in time is relevant when measuring historical evolution, Is it relevant to assess a downturn period that existed 20 years ago?

b) Which period does the “expected evolution” cover? What should be valid volatility in house prices for keeping the existing LGD thresholds of 10 % and 15%, and to which levels should the volatility increase before the LGD is changed? And how will changes in LGD take into account banks frequent (e.g. quarterly/twice yearly) updates of the market value that they retrieve from reliable sources? Could LGD be changed differently between countries for the same volatility? More common/consistent decision basis for higher LGD values should be made. There should be a maximum LGD value, or this may indicate unrealistic loss rates or fall in house prices.

d) Some guidance should be given. The draft does unfortunately allow for all possible combinations, values and time horizons, examples could be given. The basis for changing LGD should be much more limited.

*Article 5.5*

We do not understand why banks should fine-tune their LGD parameters and risk weights due to uncertainty around expectations.

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

It should be required for the competent authorities to specify why it is deemed to be better for the financial stability to have a high LGD-floor rather than to have more risk efficient, risk sensitive LDG-models. These consideration could be implemented in article 6. There should be no other conditions to be taken into account.



*Drafting suggestion article 6*

*Article 6*

*Other conditions when setting higher minimum LGD values*

For the purposes of Article 1(2)(c), competent authorities shall determine all of the following:

(a) an explanation as to why increasing the minimum LGD value is deemed to mitigate the financial stability considerations referred to in Article 3 of this Regulation,

(b) an explanation as to why the minimum LGD values are increased in a way that ensures correspondence between the higher minimum LGD value and the LGD expectation related to that portfolio as referred to in Article 5(1)(b) of this Regulation, especially explaining how the LGD expectations are such that the LGDs approved in the IRB models, which are to be appropriate for an economic downturn, are not considered to be sufficiently conservative;

(c) an assessment of the potential pro-cyclical effects of setting higher minimum LGD values in the current stage of the economic cycle on the financial stability considerations referred to in point (a);

(d) specify why it is considered that this increase has a better effect than increasing LGD levels in approved, risk sensitive, IRB models alone.

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