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FBF RESPONSE TO EBA CONSULTATION PAPER ON CONDITIONS FOR CAPITAL REQUIREMENTS FOR MORTGAGE EXPOSURES (EBA/CP/2015/12)

I- General comment

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

The FBF welcomes the opportunity to comment on the EBA's Consultation on conditions for capital requirements for mortgage exposures. Please find our main comments below.

We would like to highlight the following as a preliminary issue:

- Scope of the consultation
 - Categories are not aligned
 - Article 124 (STD approach) relates to all portfolios
 - Article 164 (IRB approach) relates to the retail portfolio only
 - Is the EBA intending to align these categories in the future?
 - What is the level of expected portfolio granularity? How will this be operationally implemented?

Moreover, in the consultation paper, the EBA stresses the need to ensure consistency of institutions' prudential requirements considering the mandatory reciprocity provision laid down in articles 124 (5) and 164 (7) of the Capital Requirement Regulation ("CRR")¹. Thus we would also like to raise the issue of the "governance" envisaged to ensure that a decision taken in a Member State is in line with the objective of level playing field.

¹ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

This issue is all the more important in the light of the report² published by the EBA in July 2015 on macro-prudential policy measures implemented and notified by National Competent Authorities (“NCAs”) following implementation of the “CRD IV package”. According to the report 32 macro-prudential measures were notified to the EBA over the 5 quarters within the scope of the report by 14 Member States plus Norway. 15 measures were introduced to address real estate risks.

In particular, the EBA points out in the report that NCAs currently have significant flexibility to decide which measure to implement in order to cope with macro-economic issues, including Pillar 2 measures, and that the rationale for their decision as well as the purpose of their choice were not always blatant. As the Authority puts it, this flexibility can be seen as a strength or « *a significant weakness, showing that too much of an overlap exists across tools and that there is a need for further harmonisation* ». Furthermore the EBA acknowledges in its report that the complexity of the current framework can lead to reduced transparency and comparability of capital requirements for banks across the EU and that more guidance regarding « *cross-border effects and reciprocity* » could avoid an uneven playing field or spillover effects.

We support the need for flexibility to allow NCAs to take into account the specificities of their national real estate market. Yet considering the reciprocity clause, we also share the EBA’s concern regarding potential negative effects on comparability, transparency and level playing field. As a matter of fact, article 124 (2) CRR requires NCAs to consult the EBA on the adjustments to the RW and criteria applied but article 164 (5) requires only notification of the EBA of any changes to the minimum LGD values. We understand, as explained in the consultation paper, that :

- the consultation process referred to in article 124 (2) CRR implies an assessment by the EBA on a case-by-case basis ;
- EBA provides a feedback to NCAs in both cases, i.e. whether EBA is consulted under 124 (2) CRR or notified under 164 (5).

However, in order to ensure consistency and to guarantee a level playing field, we believe that a decision in relation to a more conservative prudential treatment of mortgage exposures taken by an NCA should be subject to a more formal approval procedure that could involve the Single Supervisory Mechanism, the European Systemic Risk Board (with a consistent approach at the institutional level) and the Industry. It is worth noting that the SSM is the NCA for “significant banks” –additional governance consistency should be ensured between the SSM and local competent authorities.

We would also like to highlight the fact that these rules do not apply to non-European banks which may finance some European real estate projects from their non-EU Head-Office, hence they may create a potential competition distortion at international level.

In addition, the consultation paper provides for more conservative prudential treatment of mortgage exposures by national NCAs. The document focuses on the implementation mechanism of these policy decisions, but a key issue is the quality, the independence and the reliability of the information these decisions are based on. As a matter of fact, we would like to draw the EBA’s attention on how can NCAs ensure that data are coming from independent sources. This is especially true for commercial real

² EBA Report on The range of practices regarding macroprudential policy measures communicated to the EBA – July 2015. The European Systemic Risk Board also released in June 2015 a similar report : « A review of macro-prudential policy in the EU one year after the introduction of the CRD/CRR ».

estate exposures for which a lot of market information is coming from brokers. Brokers' data are limited to that of their client base –due to the nature of their business model, the information they provide is for marketing purposes hence not best suited for independent assessments.

The consultation also raises the question of the reversibility of potential additional measures taken by NCA in case of return to better economic circumstances. We encourage NCAs to review and justify annually their decisions to avoid both i) a ratchet effect leading to a one-way increase of RW / LGD floors without a possible return to regulatory levels and ii) a spill-over effect between NCAs which may lead to a benchmarking between jurisdictions based upon the decisions made by the others. There may be an issue in that these decisions may be pro-cyclical, especially if they are not reversible, hence may put the real estate market in a given country at odds with the economy of that country, of the Eurozone, and / or the EU.

Last but not least, the possibility to increase RW / LGD floors might be redundant with countercyclical buffers, which already intent to cover economic overheating within the EU banking sector.

Please find our detailed feedback within our answers to the EBA's questions.

II- Answers to questions related to the consultation

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)?

We would like to put forward the following suggestions in order to improve clarity of the draft Regulation and transparency of the NCAs decisions:

Article 1 of the draft Regulation states that NCAs shall take into account three categories of conditions. The third category of conditions, labelled as "other conditions", is defined by article 4, when considering the opportunity to set higher risk weights ("RW"), and article 6 as regards setting higher minimum LGD values.

Articles 4 and 6 mentioned above comprise a first set of "other conditions" that includes:

- an explanation as to why increasing the RW or minimum LGD is deemed to mitigate the financial stability considerations, as defined in the draft Regulation ;
- an explanation as to why the RW or minimum LGD are increased in a way that ensures correspondence between the higher risk weight and the loss expectation related to one or more property segments/the higher minimum LGD value and the LGD expectation of the concerned portfolio;
- an assessment of the potential pro-cyclical effects of setting higher RW or minimum LGD values in the current stage of the economic cycle on the financial stability considerations.

We consider that these conditions, or steps, are essential for an NCA in the process of determining whether it should increase or not the RW or minimum LGD value. Therefore we would suggest amending the draft Regulation to include these conditions in article 1 as mandatory steps the NCAs

must complete before deciding to increase RW or minimum LGD values and not categorize them as « other conditions ».

Moreover, the explanations and assessment mentioned above would be most instrumental for credit institutions to understand the decision taken by the NCA, particularly when the NCA decides to set higher minimum LGD values since the draft Regulation doesn't include any LGD indicative benchmarks. These three conditions could therefore be considered as « transparency measures » and we would strongly support their disclosure, although the CRR does not include any requirement regarding such disclosure. However since CRR requires the EBA, pursuant to articles 124 (2) and 164 (5), to publish RW and LGD values, these elements could be included in such publication.

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?

Article 2 (2) of the draft Regulation states that when adjusting the loss experience to determine the loss expectation, NCAs shall take different criteria into account and in particular:

- historical and expected evolution of prices and volatility in these prices in the immovable property market;
- time horizon over which the forward-looking property market developments are expected to materialise;
- fundamental drivers of demand and supply;
- past and present structural and cyclical characteristics of the immovable property market (historical volatility in immovable property prices, the size of the immovable property market, national taxation systems and the national regulatory provisions for buying, holding or letting immovable property).

These criteria are also used to determine the LGD expectation, pursuant to article 5 of the draft Regulation and the last criterion listed above, past and present structural and cyclical characteristics, participates to the definition of financial stability considerations (article 3 (1) (c) of the draft Regulation).

We suggest amending the wording of point (e) of article 2 (2) of the draft Regulation to allow NCAs to take into account other characteristics which could impact developments in the immovable property markets and are related to specific practices of certain Member States. In France for instance, the risk of default on mortgage loans remains low since credit extensions and lending conditions are based on the borrower's creditworthiness and thus on the stability of the borrower's income. This practice of assessing the risk of default is independent of changes in real estate property prices unlike in other Member States such as, in particular, the UK, Spain, Denmark or the Netherlands where property-value based mortgage loans are the rule. In those Member States, where loans are secured by the value of the property asset, households can make mortgage equity withdrawals for purposes other than home purchase against the equity in their property. Due to these risk assessment methods, residential mortgage loss rates incurred by institutions are structurally low in France regardless of property prices.

Point (e) of article 2 (2) of the draft Regulation could therefore be drafted as follows:

- e) ~~the past and present structural and cyclical~~ characteristics of the immovable property market, ~~where~~ whether structural characteristics which may relate to the historical volatility in immovable property prices, the size of the immovable property market, national taxation systems and the national regulatory provisions for buying, holding or letting immovable property, cyclical characteristics or other characteristics deemed relevant to determine forward-looking developments ;

We would like to emphasize that the historical evolution of prices may not provide an adequate representation of the French real estate sector. The decision to lend in France is based on the solvency of the borrower; therefore loss ratios are better indicators of the resilience of the French real estate market. We suggest that the EBA considers loss ratios as important criteria amongst its “other conditions” when setting conditions for higher RW / LGD floors.

Furthermore we would appreciate a feedback from the EBA on “IP losses” reports (Article 101 (1) c) & f) CRR). It could be useful :

- to ensure consistency in practices among banks and Member States on how these reports are filled in;
- to establish what conclusions could be drawn on financial stability.

**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?**

We do not share the EBA’s methodology underpinning benchmarks calculations. The 0.3% level of losses mentioned in paragraph 3(a) in articles 125 and 126 of the CRR is a precondition for the assessment of the level of guarantee applied to residential and commercial property respectively. The 0.3% reference is therefore not appropriate; as a result the lower bounds of the indicative benchmarks proposed by the EBA are not relevant.

The data brackets proposed by the EBA as indicative benchmarks under the standardised approach for loss expectations are too low both for the residential and for the commercial real estate portfolios. We believe proposed values are calculated on a purely theoretical basis and are not an adequate reflection of the portfolios risk profiles. We therefore would like to suggest that the EBA reviews these values in light of loss expectations back-testing based on loss experience data widely available at national competent authority level (for example on the “IP losses” reports). An impact assessment by the EBA of proposed indicative benchmarks would be welcome.

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

See our answer to question 2 as regards structural characteristics determining forward-looking immovable property market developments (article 3 (1) (c) of the draft Regulation).

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.)

See our answer to Question 1.

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?

See our answer to Question 2 regarding the determination of loss expectation and the elements NCAs should base their adjustments on.

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

If the three conditions (explanations as to why increasing RW or minimum LGD values and how this increase ensures correspondence with loss or LGD expectation and assessment of pro-cyclical effects) are included in article 1 of the draft Regulation, as suggested in our answer to Question 1, article 6 could be deleted.

In addition if an NCA decides to take a macro-prudential measure to increase minimum LGD values, it should have demonstrated beforehand that the decision to increase capital requirements stabilizes the market and will not generate any pro-cyclical effects.

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

As pointed out in our general comments to this paper, the EBA's consultation provides for more conservative prudential treatment of mortgage exposures by national NCAs; these decisions must rely on high-quality, independent and reliable data.

As the EBA points out on page 25 of its consultation paper "[...] data indicators are unfortunately not always available in all national immovable property markets [...]". As already stated in our general comments, we would like to raise the EBA's and the NCA's level of awareness to this point, especially as far as commercial real estate exposures are concerned, and encourage them to use extra care in relation to data sources underlying their decisions to increase RW / LGD floors on real estate exposures.