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Answers of the European Financial Congress to the questions asked in the European Banking Authority's Consultation Paper[1] on Regulatory Technical Standards on conditions for capital requirements for mortgage exposures

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[1] www.eba.europa.eu/documents/10180/1134425/EBA-CP-2015-12+CP+on+RTS+on+RWs+and+LGD+Values.pdf

I. Methodology for the preparing of the answers

The answers were prepared in three stages:

Stage 1

A group of experts including more than 30 specialists were invited to participate in the survey. They received the description of the project and the questions. The experts were guaranteed anonymity.

Stage 2

The Gdańsk Institute for Market Economics[2] received 11 opinions (from individual experts, expert groups and institutions). All the responses were collected, anonymised and presented to the experts who took an active part in the consultations. The experts were asked to mark in the other consultation participants' opinions the passages that should be included in the final position. Experts could also adjust their positions under the influence of arguments by other experts that they had not known previously.

Responses were obtained from:

- commercial and mortgage banks;
- investors into real estate;
- representatives of regulatory bodies;
- university professors.

On the basis of the responses received, a synthesis of Polish experts' answers has been drawn up.

Stage 3

On the basis of the survey project coordinators from the European Financial Congress prepared the final version of the European Financial Congress's answers.

[2] Instytut Badań nad Gospodarką Rynkową (IBnGR) – the first independent think tank in Central and Eastern Europe, founded in 1989 by a group of economists associated with the democratic opposition and the "Solidarity" movement.

II. Answers

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)?

The categories listed in Article 1 are correct, however they are not all the factors which should be taken into account. It is silently assumed that losses may only result from an insufficient collateral value. However, the demand to increase collateral will not solve the problem as the quality of loans, especially long-term loans, has been gradually deteriorating. This factor must also be reflected in the standard.

It is worth emphasizing that observations of long-term trends, both in immovable property markets and markets for loans secured by mortgages, are relatively short-term in the new European Union member states, which is due to the fact that free-market economies have a relatively short history in those member states.

As far as the Polish market is concerned, what is also important is the share of retail exposures secured by mortgages in banks' assets, which is relatively high, and the share of exposures financing commercial immovable property in banks' assets, which is relatively low. Our lending history is too short for adequate conclusions to be drawn as to the behaviour of portfolios at different stages of the economic cycle. Therefore, greater caution on the part of the competent authorities may be warranted.

The main categories of conditions specified for the purpose of determining of risk weights and LGD values are as expected. The level of generality, particularly of the provisions involving *financial stability considerations* and *other conditions*, is high and gives a high degree of discretion to competent authorities; however, that is warranted by the wide scope of application and the required appropriate level of generality of the guidance. This also means that the final assessment of the method of calibration of risk weights and the LGD parameter will depend on the practical solutions used by each competent authority, which are not yet known.

It seems that the high number of conditions which must be analyzed by the competent authorities of a given country in order to increase minimum risk weights and LGD floors will make it possible to address the issue comprehensively. However, it is important to have data on the basis of which it can be reliably stated that the risk weight and LGD floor increase criteria are met. Competent authorities should be required to create and support the development of inter-bank databases comprising such information.

It should be borne in mind, however, that for the Polish banking system, which is already applying stricter requirements for the financing of the immovable property market than is the case in other countries (a higher risk weight, Recommendation S requirements), any further increases of prudential requirements for the financing of immovable property in Poland will result in the inflow of competitive financing from abroad, giving rise to a deterioration in the financial situation of the Polish banking sector. An additional condition should be created, namely that banks which are not located in a given country but which invest in it should also be required to increase the risk weights or LGD floors (as is the case with the anti-cyclical buffer).

Setting higher risk weights is required both from banks which apply the Standardised Approach (STA) and from those which apply the Advanced Approach (IRB) The higher risk weights should not distort the competition between banks which apply different methods (STA or IRB). Banks

which apply the IRB approach are expected to modify the LGD parameter. At the same time, capital requirements are also affected by other parameters (PD, CCF, etc.), which the institution may control to a certain extent to its own benefit. On the other hand, the LGD parameter is not constant over time, hence it may to a certain extent reflect the current market conditions, therefore its increase may multiply the effect of its introduction.

The abundance of factors which may cause risk weights to be increased, and their application in different countries by respective competent authorities, may give rise to differences in the assessment of the situation by the competent authorities in each country. This mechanism may also improve competitiveness of banks from specific countries (at the expense of their stability).

Question 2:
a. Do you agree with the conditions for specification of the loss experience and the loss expectations?

b. 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?

You cannot identify forward-looking residential immovable property market developments on the young Polish market with adequate probability, what with the unstable tax laws and frequently-changing residential property buyer support schemes. Forward-looking commercial immovable property market developments may be identified with higher probability and the answer may be affirmative in this respect.

Moreover, the adopted basis for the determination of the loss experience and the loss expectation is imprecise. In our opinion, the statistics set out in Article 101(1) CRR do not make it possible to reliably determine the economic loss experience. The loss experience (or rather its changes over time) is in turn supposed to be the basis for the determination of the related loss expectation. What is also relevant to the setting of risk weights is the potential future level of unexpected losses and not only current loss expectation forecasts. In particular, the ratio of the unexpected loss to the loss expectation also changes over time and depends on several factors, not all of which are indicated.

From the perspective of some countries (including Poland), what is missing is perhaps a factor involving exchange rate volatility where there is a significant proportion of loans denominated in foreign currencies.

The approach expressed in Questions 2 and 3 is incorrect also for another reason. For assets secured by mortgages, the relationship between losses on the mortgage portfolio and the risk weights is much more complex than Article 2 of the draft appears to suggest. Loans secured by mortgages are of high quality early in their tenure. Their quality begins to deteriorate after about five to seven years. The level of losses will be completely different on a stable market with a stable and small growth rate than on a market where the growth rate of new loans granted is high and variable. In particular, the introduction of loss limits as referred to in the explanation to Questions 2 and 3 is hard to accept as the draft RTS are to be qualitative in nature, indicating the necessary analysis factors and the procedure for the translation of the results into specific risk weights. However, they must not impose any values. No one should have the impression that the purpose of the RTS is to prevent excessive risk weight increases rather than setting them too low. Therefore, no additional limitations should be

imposed on competent authorities, going beyond those specified explicitly in Articles 124, 126 and 164 CRR.

Question 3:
a. 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)?

The differentiation of weights due to national specificities is by all means reasonable. Although the differentiation of the benchmarks across different countries is necessary, EBA should not interfere with the detailed determinations made by national competent authorities (unless there are dramatic deviations) as that diminishes the responsibility of each bank and local regulator for rational decisions in this area.

b. What levels of these indicative benchmarks would be most appropriate and why?

For loss expectation justifying the 35% risk weight of exposures, the lower limit of 0.1% is too low, whereas the upper limit of 1.5% is too high (it could be 0.75%). For the 50% risk weight, the limit could be set at 1.0%.

Question 4:
Do you agree with the specification of the term of "financial stability considerations" in Article 3?

Yes, although the wording of Article 3(1)(a) gives preference to the old European Union member states where the majority of global systemically important institutions are located.

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.)

The entire Article 4 appears somewhat unclear – by definition, competent authorities are supposed to be able to take account of "other factors" on the basis thereof, while the provisions in fact boil down again to the setting of benchmarks for the loss expectation.

Question 6:
a. Do you agree with the conditions for specification of the exposure weighted average LGD and the LGD expectation?

The average LGD should be statistical in nature and it should not be the benchmark for the specification of indicators in national markets.

b. 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?

The other qualitative conditions seem to be selected correctly. The quantitative recommendations, however, should be removed. The market for immovable property and loans secured by mortgages on immovable property is very complex, strongly dependent on several national macroeconomic factors. For that reason, unconditionally binding quantitative

recommendations will be absolutely inadequate to the actual problem and they may do more harm than good. Moreover, if the solution was so simple as the draft RTS suggest, the legislator would place it in the CRR instead of introducing a national option in the Regulation.

It should be borne in mind that the historical data is often incomparable in the new European Union member states due to the system transformation which they have undergone; therefore, any developments used as the basis for adjustments have lasted not more than about a dozen years.

c. 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?

An immovable property market is a local market, with all the consequences thereof. We believe that the specificities of national immovable property markets should be taken into account.

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

Yes, although the sentence in (2)(c) should probably be verified – the setting of higher minimum LGD values should have anti-cyclical and not pro-cyclical effects.

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

It is a very good thing that the regulator invites suggestions on the effects of the regulation as part of the consultation process. A relevant expert opinion is definitely worth preparing. This would, however, be both time- and work-consuming. This is a task to be performed over a longer period of time, by a larger team of experts.

This data set does not seem to be necessary, yet it will do no harm if it is treated as an illustration. It does not seem to be necessary to point competent authorities to the essential variables as the authorities usually perform more complex analyses and they are also familiar with financial stability considerations and their assessment. However, although it is redundant, it may stay if this will improve the quality of the RTS.

It is worth adding the following indicators:

- time needed to complete a sale transaction on the market for a specific type of immovable property;
- the average immovable property debt collection period.

III. General comments on the proposed RTS

Articles 124 and 126 CRR make it possible for national authorities to set higher risk weights for exposures secured by residential or commercial immovable property and a higher LGD parameter for banks applying the Advanced Approaches. Higher risk weights shall be determined based on an assessment of the following three factors:

- the loss experience;
- forward-looking immovable property market developments;
- financial stability considerations.

Where the assessment demonstrates that the standard risk weights or the LGD parameter do not reflect at least one of the above factors, the competent authorities shall make appropriate adjustments corresponding to the actual level of the risk. This general authorization is to be supplemented with regulatory technical standards setting out the conditions to be taken into account when determining higher parameter values, whose draft, prepared by EBA, is the subject of this consultation.

First of all, it should be emphasized that the solution introduced in Articles 124, 126 and 164 of the CRR is a special solution. Therefore, it merits a comment before proceeding to comments on the draft RTS.

The CRR, in line with Basel III, presents two approaches to assessing credit risk and allocating appropriate capital thereto: the Standardised Approach, based on fixed risk weights, and the Advanced Approaches, based on risk models. The first approach does not allow any discretion to the bank or the competent authorities, whereas under the second approach, the bank's discretion may be high and its actual scope is subject to the competent authorities' approval. The data collected in recent years demonstrates that, for exposures secured by mortgages, the effective credit risk weights calculated on the basis of the Advanced Approaches are usually lower, and often much lower, than the corresponding weights applied under the Standardised Approach. Moreover, there are differences between effective risk weights for similar immovable property, even within one market.

The option under discussion introduces a third, intermediate solution. For the Standardised Approach, it allows the use of a non-quantified risk weight within the range 35% to 150% (residential property) or 50% to 150% (commercial property). In this sense, this is highly similar to the Advanced Approaches, but has significant limitations compared with them:

- the risk weight may only vary within a specified range, which means that even if the assessment points to a weight below the lower limit or above the upper limit, the final value must lie within the relevant range;
- the risk weight is determined by the competent authorities and not by banks – therefore, this quasi-discretion is allowed to each bank which applies the Standardised Approach, irrespective of the level of its sophistication in the assessment and modelling of risk of exposures secured by mortgages;
- the risk weight set by the competent authorities shall apply across the entire jurisdiction of the given competent authority and shall not give rise to any regulatory arbitration which may involve banks which apply the Advanced Approaches.

The philosophy of the consulted draft introduces some inconsistency: banks may apply the Advanced Approaches with their competent authorities' consent. Such consent presupposes a detailed analysis of the model itself, the conditions for its application, testing, calibration. This means that the competent authorities take a certain amount of responsibility for the application of the model. In consequence, the competent authorities have appropriate qualifications to allow the application of complex credit risk models. However, for incomparably simpler models, strongly limited by boundary conditions, whose application gives rise to uniform higher risk weights for exposures secured by mortgages across the whole market, the competent authorities' qualifications must be replaced with a detailed regulatory standard.

This inconsistency is explained by the need to harmonize the market and prevent regulatory arbitration. However, this argument may be misguided. You can only speak of arbitration where one country applies more favourable regulatory solutions whereby banks supervised thereby groundlessly achieve a more favourable position on the market than their competitors in other countries. This is not the case here for the following reasons:

- the risk weight indicated in the CRR is the minimum weight and it may only be raised, which increases the cost of mortgage lending; therefore, the exercise of the option set out in Articles 124 and 126 CRR puts banks in the given jurisdiction in a worse position than their competitors in other countries;
- despite many efforts to breathe new life into the single market for loans secured by mortgages, they are usually not granted on a transnational basis – there are several reasons for that, for instance non-harmonized immovable property market laws and regulations, which make it very hard for banks to satisfy debts using property collateral in other member states; however, these reasons do not include an overly restrictive regulatory approach to loans secured by mortgages;
- if any country increases the risk weight, the CRR does not envisage the application of the principle of reciprocity by the other countries, therefore banks from the other countries which would nonetheless like to enter the given market would be in a more favourable position than local banks for which the cost of crediting would be higher than for their competitors.

The same arguments may be applied to the setting of higher minimum LGD values. Bearing the above arguments in mind, the option set out in Articles 124, 126 and 164 CRR does not pose any threat to competitiveness on the EU market for loans secured by mortgages. On the other hand, it makes it possible to enhance stability and safety of that portfolio. Therefore, it would be simply strange or even incomprehensible for the draft RTS to introduce any limitations on the discretion to increase risk weights, naturally within the limits set out by the CRR. In consequence, we cannot agree with the statement comprised in the first paragraph of the explanatory box for Question 2 and 3:

> *Including benchmarks contributes to the level playing field, by avoiding for instance that one competent authority sets the risk weight for exposures fully and completely secured by residential property to 50% for a given level of loss expectations, whereas another competent authority would set that risk weight to 150% for the same level of loss expectations.*

From the prudential perspective, a risk weight specifies the level of risk associated with a given exposure which is to be covered by adequate capital. The amount of such capital, corresponding to a risk weight or based on a model, is not only intended to cover expected losses. It is supposed to cover the risk of unexpected losses. If the competent authorities notice increased

risk of a portfolio of long-term loans secured by mortgages, where such risk arises from many more factors than just insufficient collateral, then it is obliged to cover such risk with additional capital. The competent authorities should not be limited in prudential respects. Therefore, the RTS whose draft EBA has submitted for consultation should not provide detailed guidance or limitations to the competent authorities, going beyond the provisions in the CRR. What they should do is point to the factors which competent authorities should take into account in their analyses.

It should be emphasized that the authors of the draft prepared a fairly detailed set of questions together with the thesis that, on the basis of arithmetic calculations, you can specify the scope of increase of risk weights for each portfolio or exposure fully and completely secured by immovable property.

The immovable market conditions which should be taken into account by the competent authorities in order to determine the required level of risk are stated quite neatly.

What raises doubts is whether it is possible to collect the data and its validity, even if the mathematical formulae are correct. Without the introduction of orderly conditions for the collection, processing and use of market data, the whole reasoning may be of purely theoretical significance.