



2018-09-25

## The European finalisation of Basel III

### Summary

The document *Basel III: Finalising post crisis reforms* contains significant changes to the overall Basel framework for capital requirements. The main purpose of the changes is to strengthen the confidence in the risk-based capital framework, not to increase the level of capital in banks. Although we support many of these changes, the document contains several disadvantages that may worsen the ability of European banks to efficiently finance the economy.

From the perspective of European banks', it is highly important to keep the risk-sensitivity in the capital requirements to the greatest extent possible. With a view to maintain the risk-sensitivity of the capital requirements and to make the regulation better adapted to the European way of financing corporates and households the banking associations from Denmark, Sweden and Finland make a number of proposals for the European implementation of the finalisation of Basel III standards.

### *Output floor*

Fundamentally, we regard the output floor as unnecessary given the current possibilities to address model risk under Pillar 2 and the initiatives underway to enhance confidence in the application of IRB models and reduce undue variability in capital requirements, as well as the implementation of a leverage ratio backstop to the risk weighted capital requirements.

As it stands the output floor will trigger the largest impact of Basel III finalisation for European low-risk banks. A binding output floor will significantly decrease the risk-sensitivity in the capital requirements.

We regard this as a major setback that will potentially have negative effects on financial stability and on banks' incentives for improving risk management. The output floor will create a wedge between regulatory risk weights and the risk weights according to internal models. It will increase the incentive to take on high risk exposures at the cost of low risk exposures, which may drive more risk into the financial system. In order to reduce the impact on risk sensitivity for European banks, we propose an EU-implementation where the output floor is one of three parallel capital requirements and based on the following Basel core capital requirements (CET1):

- Minimum requirement, at least 4.5% of risk-weighted assets
- Capital conservation buffer set at 2.5% of risk-weighted assets
- Countercyclical buffer, in case it is nationally applied
- G-SIB buffer, in case the bank is identified as a G-SIB

#### *Unrated corporates*

For unrated corporates we propose that IRB banks should be allowed to use their regulatory approved internal ratings to classify corporate exposures as investment grade and use a risk weight of 65%.

#### *SME exposures*

Preferential treatment of SME exposures should not only apply to SMEs in the corporate exposure class, but to all SMEs, including SME exposures in the retail exposure class and SME exposures secured by immovable property.

#### *Residential real estate*

For loans secured by residential real estate we believe that it is essential within a controlled framework to allow the calibration of risk weights downwards in jurisdictions with documented very low loss rates.

#### *Commercial real estate*

The standardised risk weights for commercial real estate should be made more granular on lower LTVs, by introducing one or two LTV-buckets below 60%.

#### *Valuation of property*

Finally, regarding the valuation of property we propose that property values should at least be updated, upwards and downwards, each time a mortgage loan is prolonged.

## **Introduction**

The document *Basel III: Finalising post crisis reforms* contains significant changes to the overall Basel framework for capital requirements. The main purpose of the changes is to strengthen the confidence in the risk-based capital framework, not to increase the level of capital in banks. Although we support many of these changes, the document contains several disadvantages that may worsen the ability of European banks to efficiently finance the economy.

From the perspective of European banks, it is highly important to keep the risk-sensitivity in the capital requirements to the greatest extent possible. This means that banks should be incentivised to have more capital for high risk exposures and less capital for low risk exposures. The interaction between a standardised approach for credit risk without a sufficient risk-sensitivity and an output floor based on the standardised approach, will be counterproductive in this respect. With blunt capital requirements that do not reflect the risk of exposures, cost of lending will not follow the credit worthiness of the customer and thus will be too high for many low risk customers, and too low for high risk customers. Capital requirements that do not correctly reflect actual risks will thus have an impact on the allocation of finance to the economy and will in practice support high risk loans. This may affect financial stability negatively by driving more risk into the system, contrary to the objective of the revised Basel framework.

Risk weights for different exposures that reflect the borrower's credit quality are also important for banks using the standardised approach for credit risk. However, for these banks it is also a priority to have the possibility to use methods for determining risk weights that are not excessively complicated. It should be noted that the new standardised approach is in many ways better than the current one. Among institutions using standardised approach there is support for many of the planned changes as presented by the Basel committee.

With a view to maintain the risk-sensitivity of the capital requirements, and to make the regulation better adapted to the European way of financing corporates and households, the banking associations from Denmark, Sweden and Finland make a number of proposals for the European implementation of the finalisation of Basel III standards framework.

## **The output floor**

The largest impact of finalisation of Basel III standards for European low-risk banks will be triggered by the output floor, depending on how it will be implemented. If the output floor is the binding constraint it will:

- Increase capital requirements for many banks, especially for low risk lenders
- Decrease the risk-sensitivity in the capital requirements
- Incentivise banks to increase their high-risk lending
- Raise the cost of lending for both households and corporates

We regard this as a major setback that will potentially have negative effects on financial stability and on banks' incentives for improving risk management.

Notwithstanding these serious disadvantages associated with the output floor, we regard the output floor as unnecessary given the current possibilities to address model risk under Pillar 2 and the initiatives underway to enhance confidence in the application of IRB models and reduce undue variability in capital requirements. Furthermore, the introduction of the leverage ratio requirement as a "hard capital requirement" will provide an effective capital back-stop for risk-based capital requirements, including capital requirements based on the IRB approach.

If, however, an output floor is introduced into EU regulation, any possibility to implement a Basel compliant output floor in a way that helps retaining a risk sensitive capital requirement framework deserves careful consideration.

The output floor requirement is only briefly described in the Basel document (p 137-138). It is stated that banks must meet the following core capital requirements (CET1):

- Minimum requirement, at least 4.5% of risk-weighted assets
- Capital conservation buffer set at 2.5% of risk-weighted assets
- Countercyclical buffer, in case it is nationally applied
- G-SIB buffer, in case the bank is identified as a G-SIB

The total capital requirement (expressed in CET1) to be used for the output floor requirement is thus 7% (minimum requirement 4.5% plus capital conservation buffer 2.5%) plus any countercyclical buffer and G-SIB buffer.

Some jurisdictions, particularly in Europe, have chosen to use additional capital requirements, such as systemic risk buffers, O-SII buffers and various types of Pillar 2 buffers. These requirements are, however, not included in the Basel framework and should therefore not be used for the calculation of the output floor requirement.

Our view is that if the output floor is included in the EU financial legislation it should be implemented as one of three parallel capital requirements:

- 1) The risk-based requirement
- 2) The output floor requirement
- 3) The leverage ratio requirement

The risk-based requirement shall consist of the Basel requirements listed above plus any requirements for systemic risks, Pillar 2 etc. where jurisdictions find that appropriate (as it works today).

The output floor requirement shall be based only on the Basel requirements as listed above.

The leverage requirement should be 3% plus any G-SII buffer add-on.

Banks should calculate separately the risk-based capital ratio (using internal models), the output floor capital ratio (72.5% of the standardised approaches) and a leverage ratio and compare these to the corresponding requirement. All three measures should be disclosed and reported by the banks.

As an example, a bank’s disclosure of capital requirements could look like this:

	Capital requirement ratio	Actual capital ratio
Risk based capital ratio (CET1)	12%	15%
Output floor capital ratio (CET1)	8%	11%
Leverage ratio (Tier 1)	3%	5%

In the example, it is assumed a countercyclical buffer of 1% and no G-SIB buffer. Given that the leverage ratio requirement and the output floor requirement are met, the risk-based requirement will be the binding capital constraint for the bank. This implementation would be fully compliant with the Basel Committee framework for the output floor. It would result in the output floor being a back-stop on risk-weights for most European banks, rather than the binding constraint, and it would make it possible for authorities to keep capital requirements fully risk-based.

### **Unrated corporates**

Unrated corporates would under the revised standardised approach receive a flat risk weight of 100%. For unrated SME exposures that do not qualify as retail exposures an 85% risk weight will be applied. Banks in jurisdictions that do not allow the use of external ratings for regulatory purposes may assign a 65% risk weight to both rated and unrated investment grade corporates.

In Europe, banks are the primary source of finance for most corporates. In some other jurisdictions, for example the US, many corporates opt for market funding and raise funding directly with investors.

The high and “flat” risk weight for unrated corporates will lead to misallocation of risks, which will severely impact corporates and the allocation of finance to the real economy. This is particular the case for corporates with low risk and those that do not qualify for the definition of corporate SMEs.

To overcome the fact that most companies within the EU are unrated we propose that IRB banks should be allowed to use their regulatory approved internal ratings to classify corporate exposures as investment grade (and apply a risk weight of 65%).

## **Exposures to SMEs**

Currently, capital charges for exposures to SMEs in the exposure classes retail, corporate and secured by mortgages on immovable property are reduced through the application of a SME supporting factor equal to 0.7619. In the revised Basel III standards, risk weight for exposures to SMEs in the corporate exposure class is lowered (85%) but in other exposure classes there is no corresponding reduction of the risk weights.

The purpose of the preferential treatment of SMEs in Europe is to ensure an adequate flow of credit to support and promote growth in small business undertakings in Europe regardless of whether the specific exposure to the SME was attributed to corporate exposure class, the retail exposure class or exposures secured by real estate under the standardised approach. This approach should be maintained in Europe. Therefore, preferential treatment of SME exposures should apply to SMEs in all exposure classes, except for exposures in default.

## **Residential real estate**

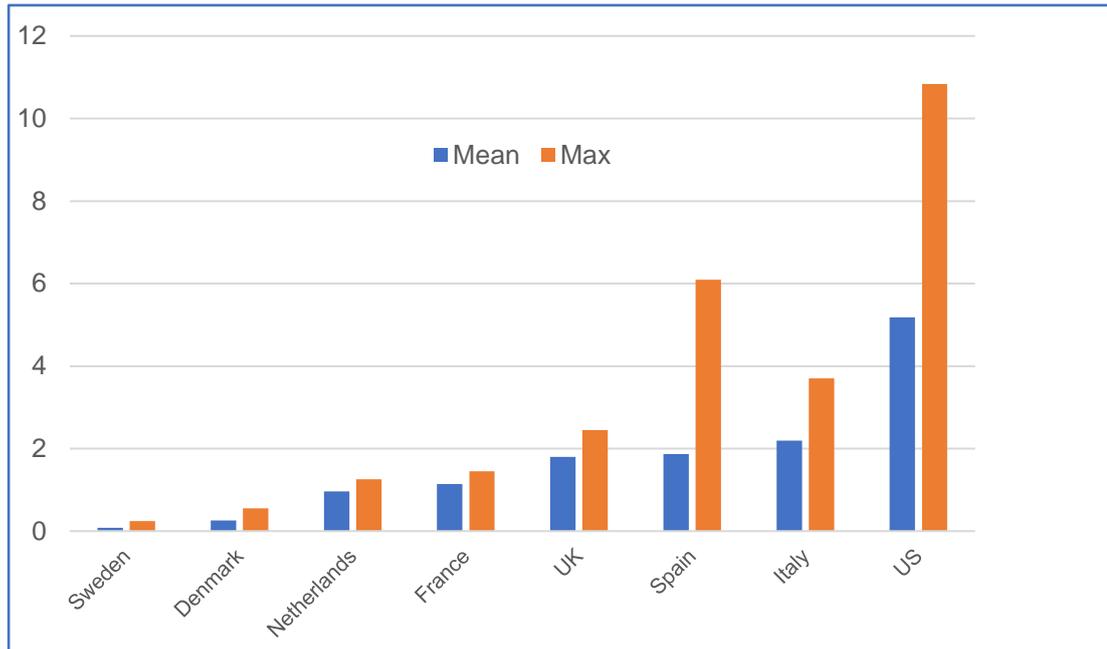
Regarding loans secured by residential property we are concerned that the risk weights of the standardised approach do not reflect the actual risk on these loans in the EU and especially in the Nordic countries. Evidence on loss experience of European IRB banks transposed into risk weights by using the formula given in the Basel III suggests that an appropriately conservative starting point for risk weights in low risk loans jurisdiction could be below 20% for loans beneath the 80% LTV bracket (*Source: EBA's Fourth report on the consistency of risk weighted assets, June 2014*).

The figure below shows the average and maximum value of defaulted mortgage loans in per cent of total value of mortgage loans outstanding over the period from 2000 to 2014 in a sample of jurisdictions.

It clearly illustrates the challenges associated with finding a simple world-wide uniform relationship according to which one or two common risk drivers are sufficient to describe the (expected and unexpected) level of loss in an institution's mortgage portfolio.

We believe that it is essential in the EU framework to leave room for calibration of lower risk weights in jurisdictions where very low loss rates can be documented based on clear and objective criteria's. The calculation of LTV ratios should be kept simple and uniform across countries.

### **Mortgage defaults in selected countries 2000-2014, per cent of outstanding loans**



Source: Mortgage arrears, regulation and institutions: Cross country evidence, Irina Stangaa, Razvan Vlahua and Jakob de Haana, De Nederlandsche Bank, 15 December 2017. Note: The study consists of information on mortgage defaults covering 26 countries. Data is collected from respective central banks or from supervisory authorities. The default rate is for most countries defined as the ratio of the total value of mortgage arrears (over 3 months past due) to the total value of outstanding mortgage loans.

Furthermore, there is a need to clarify how Basel 3 regulations treat certain residential real estate exposures, i.e. whether they are classified as retail or corporate exposure. One example is the so called limited liability housing company model which is prevalent in Finland. Exposures to these companies should be treated similarly to other exposures secured by residential real estate where the repayment is not materially dependent on cash flows generated by the property.

### **Commercial real estate**

The main principle for determining the risk weight for commercial real estate is that exposures up to 60% of the property value will have a risk weight that is the lowest of 60% and the risk weight of the counterparty, and exposures with an LTV higher than 60% will have the risk weight of the counterparty.

We believe that the new standardised approach is not granular enough for commercial real estate, and that the risk weights connected to the LTV-buckets are too high. We therefore suggest that the EU implementation of the revised Basel standard should secure that commercial real estate market portfolios with historically low default ratios should be treated with a more risk-sensitive approach. Making the standardised risk weights more granular on lower LTVs, by introducing one or two LTV-buckets below 60%, would capture more accurately the risk profile of the commercial real estate portfolios of prudent and stable banks in large parts of Europe.

## Value at origination

When calculating the LTV for real estate the value of the property will, as a main rule, be maintained at the value measured at origination.

We believe that especially the residential real estate exposure class will be negatively affected if the finalisation of Basel III-standard is implemented without adjustments into EU legislation. The concept of an LTV based on value at origination has many drawbacks. One obvious drawback is that a valuation that can be 30 or 40 years old will hardly represent a reasonable indication of the risk of a mortgage.

If a strict value at origination-approach is applied, we would have a situation where risk weights are not in line with actual risk and are not comparable between exposures. Take the case with two identical houses next to each other on the same street, with the same level of financing and with the only difference that the loans to the houses were originated at different points in time and therefore with different valuations, everything else being equal (repayment capacity by the obligors etc). It is obvious that the loans share the same risk characteristics and should have the same risk weight. But that will not be the case in the proposed LTV approach.

Our proposal is that property values should at least be updated, upwards and downwards, each time a mortgage loan is prolonged. This would increase the level of risk sensitivity. Also, it would counteract that customers change from one bank to another only for the reason of getting a more accurate value of the property.



Ulrik Nødgaard  
CEO  
Finance Denmark



Hans Lindberg  
CEO  
Swedish Bankers'  
Association



Piia-Noora Kauppi  
Managing Director  
Finance Finland

Contact:	Denmark:	Jakob Legård Jakobsen, <a href="mailto:jlj@fida.dk">jlj@fida.dk</a>
	Sweden:	Johan Hansing, <a href="mailto:johan.hansing@swedishbankers.se">johan.hansing@swedishbankers.se</a>
	Finland:	Veli-Matti Mattila, <a href="mailto:veli-matti.mattila@finanssiala.fi">veli-matti.mattila@finanssiala.fi</a>