EMF ECBC

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## Summary



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European Mortgage Federation

ECBC European Covered Bond Council

# The Future Development of EU Mortgage and Covered Bond Markets, and Implications of the Energy Efficiency Debate

By Luca Bertalot, Secretary General, EMF-ECBC

On the 3rd of June 2016, the European Mortgage Federation – European Covered Bond Council (EMF-ECBC) hosted a high level panel debate on "The Future Development of EU Mortgage and Covered Bond Markets, and Implications of the Energy Efficiency Debate" at Ca' Foscari University in Venice, Italy. The Ca' Foscari University is well-known for its research on energy and renowned for holding the world's oldest green building certificate[1]. Panellists and participants representing the interests of European investors, issuers, valuers, academics, the European Commission and the Basel Committee on Banking Supervision (BCBS), were present to discuss the future role of banks in financing energy efficiency and in addressing Europe's commitment to climate change.

### NEW TRAJECTORY

International, institutional and investor interest in energy efficiency finance has increased in magnitude in recent years, supported by the successful conclusion of the COP21, a universal legally binding global climate action plan to limit global warming to well below 2°C[2]. This has worked as a catalyst for energy efficiency finance across financial markets and imposed a new trajectory for EU Member States' engagement in energy consumption. In the European Union (EU), buildings are responsible for 40% of the total energy consumption and 36% of CO2 emissions. By improving the energy efficiency of buildings alone, the EU's total energy consumption could be reduced by 5-6% and CO2 emissions by 5%.

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1 LEED certification.

2 The Paris Climate Change Agreement adopted during COP21 in December 2015 sets out a global action plan that helps avoid dangerous climate change by limiting global warming to well below 2°C. It was adopted by 195 countries as the first-ever universal, legally binding global climate deal. The Agreement is due to enter into force in 2020

The EU has set itself an overall 20% energy efficiency savings target by 2020 and is now considering increasing this to a 30% target by 2030. The scale of investment needed to meet the 2020 target is estimated at around €100 billion per year, with it considered necessary to invest around €100 billion a year up to 2050 in the EU building stock in order to deliver Europe's commitments on climate change. With about 35% of the EU's buildings being over 50 years old, massive thermal renovation of the building stock is a necessity to reach the these climate goals.

**EMF-ECBC PROPOSAL**

The EMF-ECBC proposal, to design an "energy efficiency label" for mortgages, based on certain energy performance indicators, with a lower interest rate and additional retrofitting funds to improve the energy performance of the property, thus freeing-up disposable income and, in parallel, reducing credit risk for borrowers, lenders and investors, was presented as a starting point of the panel debate. There is a clear **underlying incentive chain** of the initiative, which rests in particular (but not exclusively) on two key tenets:

**Retrofitting** positively affects **property value**, ensuring wealth conservation & loss mitigation by preventing **"brown discount"**

**Energy efficiency** reduces the impact of energy costs to household income, reducing borrower's **probability of default.**

**EXECUTIVE SUMMARY**

Amongst the panellists and participants there was a common agreement that banks have an **important role to play** in providing long-term financing for energy improvements to the existing European housing stock, in particular, mortgage banks and covered bond issuers, given their position in the market and their intervention at a critical moment in the process of purchasing and financing a property.

**European Commission:**

The European Commission representative, Roman Doubrava of DG Energy, expressed support for the EMF-ECBC proposal, emphasising the importance of the outlined incentive chain, the additional funds available to undertake retrofitting and the added value of the de-risking features of the underlying business case. In general, the Commission expressed **support** for the proposal's ability to address the current challenges on energy efficiency financing. The EMF-ECBC market initiative corresponds with the Commission's own framework for climate and energy policies, which aims to encourage investments and overcome market barriers, and boost private finance for energy efficiency investments/buildings, with the European building stock constituting the largest single energy consumer in the EU[3].

The EMF-ECBC energy efficiency mortgage initiative gathered **positive feedback** from the Industry and stakeholders present at the panel debate for several reasons:

**Regulatory Challenges:**

The current regulatory landscape presents several challenges and concerns for the European banking industry, with increased capital requirements imposed by the European Commission in the form of the Capital Requirements Regulation (CRR), Capital Requirements Directive (CRD) and Insolvency II, and the ongoing Basel IV discussions impacting on the cost of capital. An energy efficiency mortgage label which, as shown above, impacts upon the value of the property and, in turn, reduces **asset risks** on banks' balance sheets, was seen as a **welcome advantage** by industry and institutional representatives.

The possibility to take account of an increase in the property value is also suggested in the recently published Second BCBS Consultation on Revisions to the Standardised Approach for Credit Risk[4], which, at point 52 on page 35, states that *"modifications made to the property that unequivocally increase its value could also be considered in the LTV"*.

The positive energy efficiency reductions in the impact of energy cost to a household's income were also viewed as a welcome component during the debate, as **freeing-up disposable income** has the possibility to **lower borrowers' probability of default** on their loan. The share of housing costs to disposable income equates to 42.5% for the income group below 60% median income on average across the EU and 18.7% of the income group above 60% median income. Research[5] in the US shows that borrowers financing energy efficiency works on their property have a 32% **lower probability of default** on their loan. The lower risk of the household is also recognised in Canada, where households receive a 10% Canada Mortgage & Housing Corporation (CMHC) mortgage loan insurance refund/rebate[6] on mortgage loan insurance premiums if CMHC-insured financing is used to purchase an energy-efficient home or make energy-saving renovations.

If the same correlation between energy efficient investment and default risk can be evidenced in the EU, banks will be able to demonstrate that energy efficiency mortgages are less risky due to a net cash flow saving, thus reducing the **credit risk**. Banks could therefore request a **better capital treatment** for those loans on their balance sheet which, in light of the ongoing regulatory challenges for banks, represents a **welcome opportunity** for the Industry. This would also assist in terms of meeting the Commission's aim to support jobs, growth, investment and SMEs in the EU, with a micro-economic advantage provided to all stakeholders: borrowers, lenders, investors and SMEs in terms of wealth conservation, risk mitigation, energy conservation and job creation.

**Preliminary data by CRIF:**

Ivan Luongo from CRIF presented the preliminary conclusions of a comprehensive study which analyses the added value of energy efficiency in properties by isolating the "green value" in house prices. The preliminary results show a positive correlation between energy efficiency and "green value", and an impact on payment behaviour which indicates that borrowers of the worst energy classes have **twice** the observed bad rates than the registered behaviour of best energy classes. Consequently, this reduces the **credit risk** as a result of the lower probability of default and lower loss given default (LGD) associated with energy efficient mortgages.

**Banking Supervision:**

Frank Pierschel, a representative of BaFin and of the Basel Committee's Task Force on Standardised Approaches, indicated that the **preferential treatment** of energy efficiency mortgages could be a possibility in the future, implementable via the introduction of a sub-class in the Standardised Approach to Credit Risk, conditioned on data showing a reduction in PD and LGD by increased asset value due to energy efficiency retrofitting.

Mr Pierschel also noted that **environmental issues** are currently under discussion in the Financial Stability Board from a financial stability perspective, with climate developments impacting on the insurance industry, which, in turn, impacts on property prices, equities and the other assets within banks' balance sheets. In this context, Mr Pierschel underlined the likelihood of the impact of "brown discount" on property prices in the future.

Mr Pierschel also cautioned against the introduction of harmonised green standards across the EU without addressing the currently variable valuation of properties across the European Members States.

**Gathering Market Data:**

To obtain a preferential regulatory treatment, institutional representatives stressed the importance of **gathering market data**, which can verify the

[3] http://ec.europa.eu/smart-regulation/roadmaps/docs/2016_ener_001_epbd_smart_buildings_en.pdf.

[4] http://www.bis.org/bcbs/publ/d347.pdf.

[5] 2013 University of North Carolina Chapel Hill Study.

[6] http://www.cmhc-schl.gc.ca/en/co/moloin/moloin_008.cfm.

underlying business case and support the preliminary results already gathered across several countries, such as France, Italy, the US, Canada and Japan.

In this relation, industry stakeholders pointed out that gathering and processing data on the actual financial performance of energy efficiency investments would create a **new flow in data** which, in addition to aiding the rating of the "green value" of buildings in property valuation, would generate data evidence/track records of banks' utilised collateral and asset pricing. In parallel, this would protect portfolios against the **"brown discount"**, thus mitigating risks.

Two key elements of the proposed EMF-ECBC initiative will be to create: (1) **a "data warehouse"** intended to (a) establish the correlation between energy efficiency and borrowers' probability of default and LGD, and (b) clearly register and record the link between property, energy rating and loan performance, so that these assets can be identified for "green" funding purposes; and (2) **an energy passport** recording the energy efficiency history of a property from energy rating to energy rating by recognising improvements made (or the reverses) over time.

**Green Funding:**
The EMF-ECBC initiative was also received positively by panellists from a funding perspective, with many investment banks having already established purely "green" trading desks to deal with the increased demand for sustainable investments. A clearly defined energy efficiency label for mortgages would, on its own as well as through collateral for green bonds, help reduce uncertainty regarding investments in energy efficiency and increase investor confidence, as well as support the integration of energy efficiency in portfolio management strategies for institutional investors and/or fund managers. This would also have an impact from a **risk management** point of view by segregating the "green" from the "brown discount", thus creating an incentive to **make existing energy efficiency assets visible**, i.e. segregate energy efficient assets which are currently included in the cover pool without earmarking.

**Business Opportunity:**
The combination of the regulatory challenges in terms of capital costs observed in the market today and the business case underpinning the EMF-ECBC initiative has the potential to provide banks with a welcome business opportunity, by introducing a reduction in **asset risk**, **credit risks** and **performance risks** and, potentially, a **preferential treatment** (if market data can be gathered to support the preliminary result already showing a positive correlation between energy efficiency and "green value" and reduction in LGD). In this context, it was emphasised by industry representatives that the undertaking to ensure the certification/compliance and thereby the performance risk were not to be conducted by the banks themselves but by a third and independent party.

Furthermore, it was also highlighted that the business opportunity embedded within the EMF-ECBC initiative would assist banks in their competition with institutions from the insurance and pension funds sectors, which provide many of the same services, but are not subject to the same regulatory requirements as the banking sector.

Lastly, it was mentioned that **COP22**, which will take place in Marrakech in November 2016, will cement the actions required to implement the Paris Agreement and, significantly, "green finance" will be one of the key themes of the event, underlining the relevance and timeliness of the EMF-ECBC energy efficient mortgage initiative.

# EMF Quarterly Review – Q1 2016

By Daniele Westig, Economic Adviser, EMF-ECBC

## INTRODUCTION

The first quarter of 2016 showed that in the EU[7] outstanding mortgage lending increased while interest rates continued to decrease. These two dynamics, however, show a decelerating pace with respect to the previous quarters. Furthermore, considering house prices, the overall trend was increasing, though heterogeneous among the different countries. The recent vote in the UK to leave the EU will certainly have a major impact on the figures for the next quarterly review, both for the UK itself and for the continent as a whole.

## MORTGAGE LENDING

At the beginning of 2016, in aggregate terms, in the EU the outstanding mortgage lending decreased by 0.6% y-o-y for the first time since the end of 2013. Likewise, aggregate gross lending figures show a 5.6% decrease, the worst figure since Q1 2013. While for various countries the outstanding mortgage figures show a slight decrease, in terms of gross lending there are more extreme positive and negative dynamics. Equally, in this quarter the dynamics across the continent are very heterogeneous and are influenced by both the economic conditions and legislative developments, which are described in more detail below.

In Central and Eastern Europe, gross residential lending developed positively on a year-on-year (y-o-y) basis. In **Romania**, there was over a 13% increase, which was driven by an increase in local currency loans, while foreign currency lending registered a slight fall of 4.4% q-o-q. Also, non-performing loans (NPLs) decreased further to 5% in Q1 2016. In the bank lending survey of the Romanian National Bank, the beginning of the year was also characterised by a significant increase of credit demand for mortgage loans coupled with a tightening of credit standards, principally through lowering loan to value (LTV) limits. The latter can be explained by the fact that in April 2016 the *Datio in Solutum* Law was enforced, giving mortgage debtors the right to close their loans by renouncing the dwellings given as collateral. Similarly, **Poland** increased its gross lending by nearly 4% y-o-y and at the end of Q1 2016, for the first time, the total number of residential mortgage loans exceeded 2 million contracts. Here, in Q1 2016, standards and conditions of mortgage lending were tightened due to regulatory factors, such as new provisions on the client's own contribution, which shall now amount to at least 15%, and new guidelines from the Polish Financial Supervision Authority regarding the calculation of the borrower's creditworthiness. Mortgage demand increased mainly due to borrowers' concerns regarding the near-depletion of funds earmarked for loan subsidies under the government-subsidised housing scheme "Flat for Youth", which by March 2016 had already disbursed 95% of the overall amount budgeted for the entirety of 2016; applications for this subsidy can now only be made for funding in 2017-18. Banks are also expected to tighten for the subsequent quarter. In the **Czech Republic**, considering the results of the first quarter of 2016, it is highly probable that the volume of loans provided this year will reach a new record high. Notwithstanding the surprisingly weak economic growth, in **Hungary** the gross lending in this quarter – though less than the second half of 2015 – increased by 50% with respect to the same period in the previous year. In 2016 the government has announced important changes which will affect mortgage lending activity and housing market activity more generally for at least the rest of this year. For example, the VAT for new dwellings was reduced from 27% to 5% from January 2016 and housing subsidies, especially for large families, will be more generous when buying a newly-built dwelling.

In **France**, the credit market was driven by the real estate market take-off in the new homes market, by first-time buyers and rental housing sales, which enjoy fiscal incentives. Further interest rate cuts spurred this dynamic, which saw a 7.4% y-o-y increase in gross residential lending; however, this represents a sharp decrease with respect to the 28.7% increase in Q4 2015. In **Belgium**, the first quarter of 2016 showed a decrease in the number of new mortgage loans, which went down by 7.5%, while the volume decreased by 3.6% as compared to the same period of last year. This decrease in new mortgages can mainly be explained by the exceptionally high and unprecedented number of (external) re-mortgaging transactions witnessed in the first quarter of 2015, and the much lower number of refinancing actions in the third quarter of 2015. Regarding the purpose of new mortgage loans, there has been a 33% increase in loans for house purchase, a 50% increase for construction and a 6% increase in purchase and renovation compared to Q1 2015. New loans for renovation, and particularly for re-mortgaging, fell by 15.7% and 56% respectively. If refinancing operations are not considered, Q1 2016 had the highest volume of mortgage contracts signed in the first quarter since 2008, for a total of about EUR 6 billion.

Moving to the south of Europe, in **Italy** residential lending ballooned in Q1 2016 to EUR 17,840 million, which is more than a 66% increase y-o-y. This positive trend reflects a combination of certain factors such as the improved conditions on the supply side, the increase in demand for mortgages encouraged by the strong decline in interest rates and the growth of consumer confidence. In **Spain**, gross residential lending continues to show positive momentum in Q1 2016, which is in line with the previous quarters. The y-o-y increase was 11.4%, amounting to EUR 8,172 million, out of which 15.5% corresponds to loan renegotiations. The quarter-on-quarter (q-o-q) figures show a decrease of 18.5%, which can be attributed to the political uncertainty derived from establishing a stable government and to the lower than expected macroeconomic fundamentals.

In the **UK**, positive economic fundamentals and higher earnings growth helped to underpin a recovery in the housing and mortgage market, where gross residential lending for Q1 2016 depicted a healthy 28.9% increase y-o-y. Lending in March was boosted as buy-to-let activity was brought forward to avoid the additional stamp duty land tax (transaction tax), which would have meant those buying a second property would be subject to an extra 3% tax on top of the standard stamp duty that is payable when purchasing a property. The second quarter of the year is set to be quieter as the distortion from the stamp duty change affects levels of activity, coupled with increased uncertainty in the lead-up to the UK's EU referendum vote in June. As a result, only limited potential for stronger activity and lending figures is

[7] In Q1 2016 the sample of the proxy for the amount of total outstanding mortgage lending in the EU28 included BE, CZ, DE, DK, ES, FI, FR, HU, IE, IT, NL, PL, PT, RO, SE and UK. (i.e. around 95% of the total outstanding mortgage lending in the EU28 in 2015). Please, note that at the date of publishing, Q1 2016 data for FI, NL and PT were not yet available and the most recent observations (all from Q4 2015) have been used.

expected. Other factors restricting activity are the already elevated levels of house prices relative to earnings, regulation in the home-owner space as well as the tight supply in the secondary housing market, which continues to cause supply/demand imbalances. In **Ireland**, gross residential lending grew by 2.5% y-o-y to EUR 1,008 million compared to 8.2% during the previous quarter. The volume of mortgage drawdowns fell by 3.1% to 5,446, the first y-o-y decline since Q4 2013, according to BPFI data. In addition, the number of mortgage approvals fell more sharply, by 11.3% y-o-y, to 6,028 based on the three-month moving average. Reasons for this slowdown are to be found, among others, in the introduction by the Central Bank of Ireland (CBI) of new limits on LTV and loan to income (LTI) for new mortgage lending in February 2015. Moreover, adding to the direct impact of the limits on lending, the CBI has indicated that these measures may have led to an initial surge in mortgage market activity, which may have inflated the y-o-y drop in approvals.

Moving to Scandinavia, in **Sweden** gross mortgage lending grew by 4.5% y-o-y in Q1 2016, which decelerated much from the 17.1% of previous quarter. The growth trend is due to favourable economic fundamentals, together with increasing household earnings and increases in house prices caused by the well-known imbalances between supply and demand in the housing market. In **Denmark**, gross lending plummeted by 66% with respect to Q1 2015 to DKK 47.3 billion and the outstanding figure slightly decreased by 0.5% to DKK 1,765 billion.

**HOUSE PRICES**

Nearly all countries of our Q1 2016 survey depict an increasing house price index, which shows an active market based on improving economic fundamentals throughout the EU coupled to tight supply and high demand.

In central Europe, in the **Czech Republic**, large cities as Prague and Brno accounted for a significant increase in house prices. Other regions of the country had positive and even larger dynamics in percentage terms, which was principally due to the lower baseline with respect to the larger cities. In **Hungary**, the house prices based on the HPI of FHB Bank continue the upwards trend and reached the value of the last peak in Q1 2008. Though the q-o-q increase was a mere 0.5%, considering the period since the beginning of the market upturn (April 2014 through end 2015) house prices grew by more than 28% in both nominal and real terms. This upturn can be seen throughout Hungary, but with a heterogeneous picture. The largest price increase is seen in Budapest and in central Hungary, while the most limited growth, which was still 11.5% in 2015, can be seen in western Transdanubia. The price dynamics can be also found in the housing market which saw a growth in building permits. The number of dwellings handed over in Q1 2016 was, however, lower than in the previous year. Moreover, in in the first quarter of 2016, residential property prices remained stable in **Poland** while they increased in **Romania**. Likewise, in **Germany**, owner occupied housing advanced by 4.7% y-o-y according to the vdp index. This development is also mainly caused by the persistent increase in demand in large cities and increasingly in their surrounding boroughs. The buoyant labour market together with low interest rates pushed prices for condominiums, single-family and semi-detached houses up.

Moving south, in **Italy**, house prices slightly decreased by 0.2% q-o-q and by 0.9% y-o-y. New dwellings decreased by 0.5% both y-y and q-o-q, while existing dwellings decreased by 0.1% q-o-q and by 1% y-o-y. In **France**, during Q1 2016 sales increased by 11.5% q-o-q, while generally the real estate market waits until April to awake from its winter slumber. House prices went up 0.5% q-o-q in the existing housing market, but fell by 1.3% in the new housing market. Compared to the same periods of last year the trend was positive in both markets, with respectively growth of 1.3% and 2.4%.

On the other side of the Channel, in the **UK**, even as house prices are elevated relative to earnings, house price growth continues to be strong given the tight supply of houses for sale. There is also evidence to suggest that would-be movers are being put off marketing their property as they cannot see properties they want to buy themselves, which is creating a sort of vicious cycle in the housing market. In **Ireland**, in the framework of positive economic fundamentals, with decreasing unemployment and upward trends in retail, construction and tourism, according to the Central Statistics Office (CSO) house prices experienced a 7.4% y-o-y increase in Q1 2016. Contrary to other countries, Dublin's house price increase was relatively low with growth of 3.9%, while the rest of the country rose by 10.5%. Similarly, rents grew faster outside the capital, particularly for apartments. One of the major issues in the Irish economy lies in the lack of available housing, especially suitable family accommodation. Building activity has increased in recent years with completions up 20% y-o-y in Q1 2016 according to the Department of the Environment, Community and Local Government, and building starts are up 57%. However, building levels are well below the annual estimated demand of 25,000 homes.

In **Sweden**, house prices and increasing household debts are heavily debated. House prices for one-family homes increased by an impressive 13.1% y-o-y in Q1 2016, which accelerated from 9% of previous year. With 14% y-o-y growth, the price increases of apartments have slowed down and are almost in line with that of one-family homes. In the fourth quarter of 2015, the prices on tenant owned apartments increased by around 18% y-o-y. Although construction figures show an increasing trend during 2015, the strict building standards and building permits prevent a construction boom in Sweden, and house prices are expected to grow. It is also important to mention that in spring 2016, the latest statistics showed that this trend is flattening and the increases are expected to be smaller.

**MORTGAGE INTEREST RATES**

In aggregate terms, the interest rates for a mortgage in our sample decreased in Q1 2016 by 17bp y-o-y to 2.6%[8]. The vast majority of countries continued to see their interest rates dropping, although here too the picture is heterogeneous.

For Q1 2016, though it slightly increased from the last quarters, the lowest interest rate was found in **Denmark** where households were able to find a mortgage loan at a variable rate of 1.17%. The more long-term interest rates (over 10 years) which households were able to secure stood at 3.67%, an 11 basis point decrease with respect to the previous quarter. In neighbouring Sweden, overall mortgage interest rates were stable in Q1 2016, with variable rates slightly increasing to 1.4%, medium initial fixed rates remaining unchanged at 1.6% and longer initial fixed rates decreasing to 2.4%.

In the **UK**, mortgage interest rates continued to fall in Q1 2016 on a number of measures, as lenders competed on mortgage rates to attract new customers. Funding conditions were favourable for lenders, which has also helped push down mortgage rates, which remained at or close to record lows in Q1 2016. In **Ireland**, interest rates on outstanding mortgages are also very low as they are heavily influenced by the European Central Bank (ECB) base rate, as about half of all mortgages outstanding are on tracker rates, which are just over 1%. About 33% of the value of new mortgage loan agreements, including renegotiations, was on fixed rates (those with an initial fixation period of more than one year) in Q1 2016, an 11 percentage point (pp) drop y-o-y, but a 3 pp rise q-o-q. The CBI introduced a new quarterly interest rate data series for Q4 2014, which is based on new mortgage drawdowns rather than new agreements. The standard variable rate for private dwelling house mortgage fell by 49 bp to 3.64% over the year ending Q1 2016.

In **Hungary**, the reference rate of the Central Bank stood at 1.35% at the end of 2015 and was reduced three times since reaching 0.9% in May 2016. Most typical mortgage loans carry variable rates linked to the three month Budapest interbank rate, which was 4.89% at the end of Q1 2016, continuing its slight upwards trend started in mid-2015. In **Romania** and **Poland**, interest rates remained fairly unchanged at around 3.73% and 4.40% respectively. The **Czech**

8 The calculation is a simple average of the mortgage interest rates submitted by the countries to this review (Table 5A of the Quarterly Review). If the figure for Q1 2016 was not available the latest available one was taken.

**Republic** continued its trend of decreasing interest rates in Q1 2016; however it is expected that they have now bottomed-out and may start to pick up in the coming quarters. Mortgage markets in the Czech Republic will be affected by the European Union's Mortgage Credit Directive (MCD), the implementation of which was scheduled for March 2016, but the country's parliament has not yet adopted the MCD standards, which could happen in the coming months.

In **Spain**, interest rates for new residential loans continued to decrease in parallel to the trend observed on the main benchmark index of the Spanish mortgage market (Euribor), supported by the expansive monetary policies of the ECB. The weighted average interest rate on new residential loans was 2.02% in Q1 2016, a decrease of 48 bp with respect to the previous quarter. Also, the variable, short and long fixed term interest rates all decreased q-o-q setting the rates at 1.72%, 2.06% and 2.65% respectively, with the first two reaching their lowest values since 2007. The medium fixed term, on the other hand, increased by 21 bp to 5.23%. New loans are increasingly issued with a fixed interest rate thanks to its benefits for households and financial institutions. This explains why residential loans with an initial rate fixation period of over 10 years account for 10.7% of new loans, a 56.2% increase q-o-q and a nearly fourfold increase y-o-y. As a consequence, though the majority of new loans are still issued with a variable rate, the market share in Q1 2016 decreased in one quarter by 4.8 pp to 57.8%. As previously mentioned, in **Italy** as well interest rates decreased with variable loans bearing a 1.92% interest rate, while the 10 year fixed term rate decreased by 19 bp to 2.65%.

In **France**, interest rates resumed falling in Q1 2016 after a short-lived increase in mid-2015. The average for fixed rate loans was a little higher than 2%. This being an average at the beginning of 2016, loans with 1.4% and 1.5% were also offered for low-risk loan files. The variable rate average was 1.43%, but it is used only marginally as it is seen as uncompetitive with respect to fixed rate loans. In **Belgium**, interest rates continued to decrease in Q1 2016 and the 10 year fixed period interest rate, which with 76% of the market share is the most popular, decreased by 21 bps to 2.27%.

**Figure 1 ▶ Countries where gross residential lending has remained below 50% of 2007 levels**

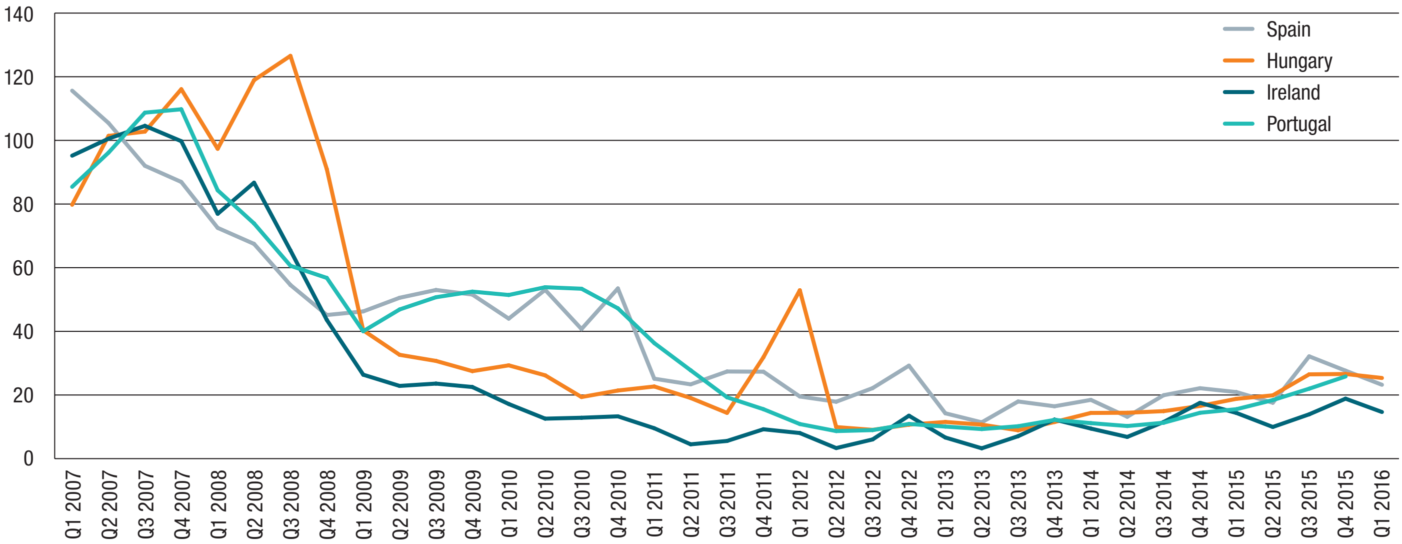



**Figure 2 ▶ Countries where gross residential lending has remained below, but above 50% of, 2007 levels**

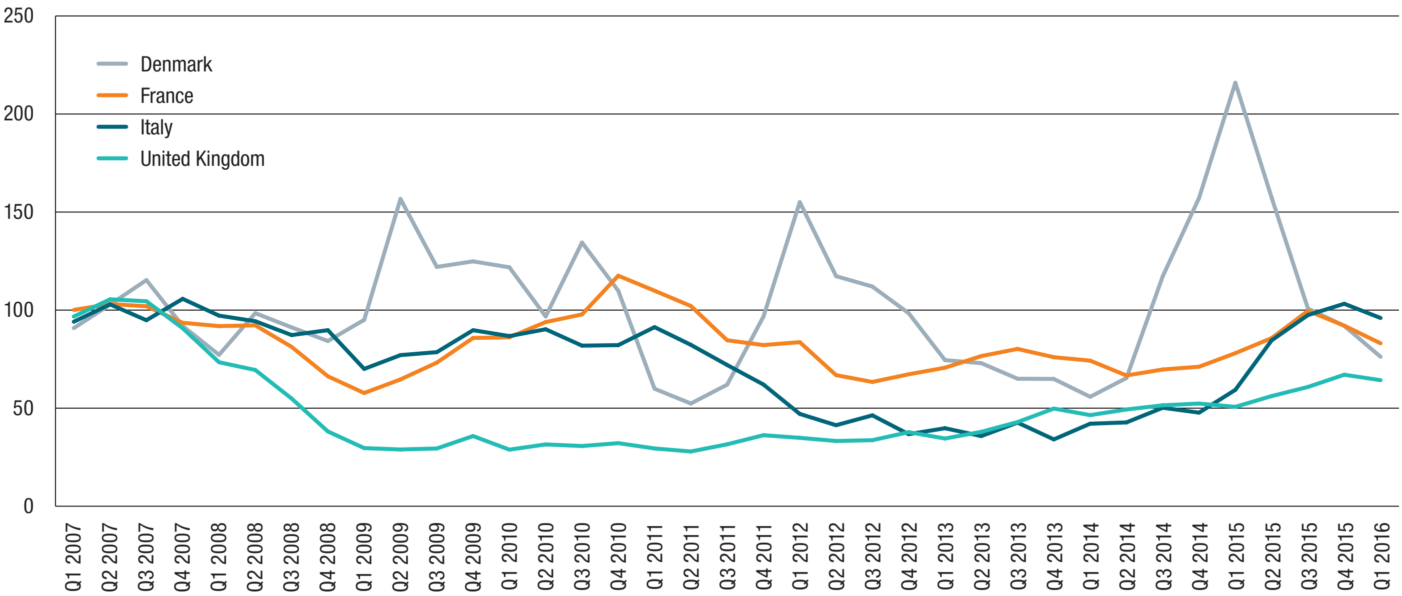
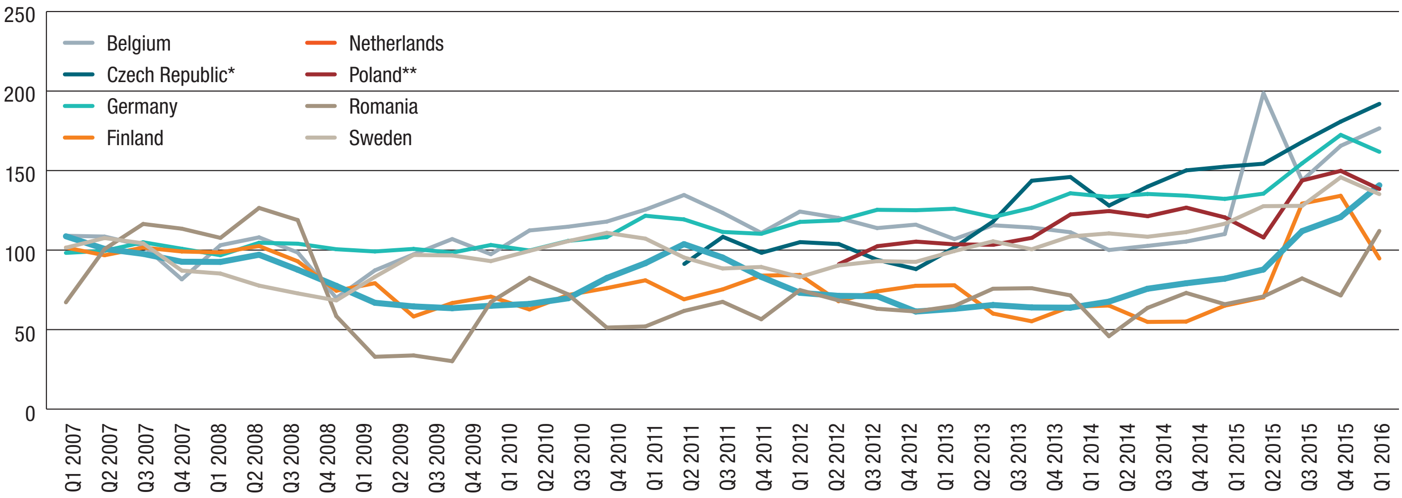
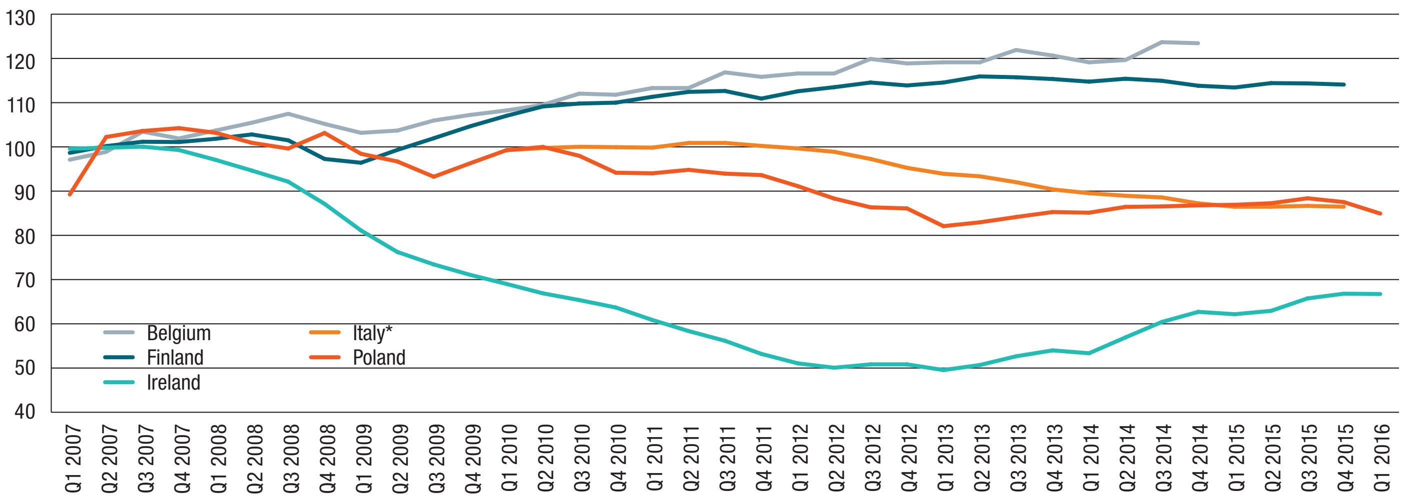


**Figure 3 ▶ Countries where gross residential lending has risen above 2007 levels**




* reference year 2011 ** reference year 2012

**Figure 4 ▶ Countries where house prices have fallen in the available latest quarter**




* 2009 = 100

**Figure 5 ▶ Countries where house prices have risen slightly over the latest quarter**

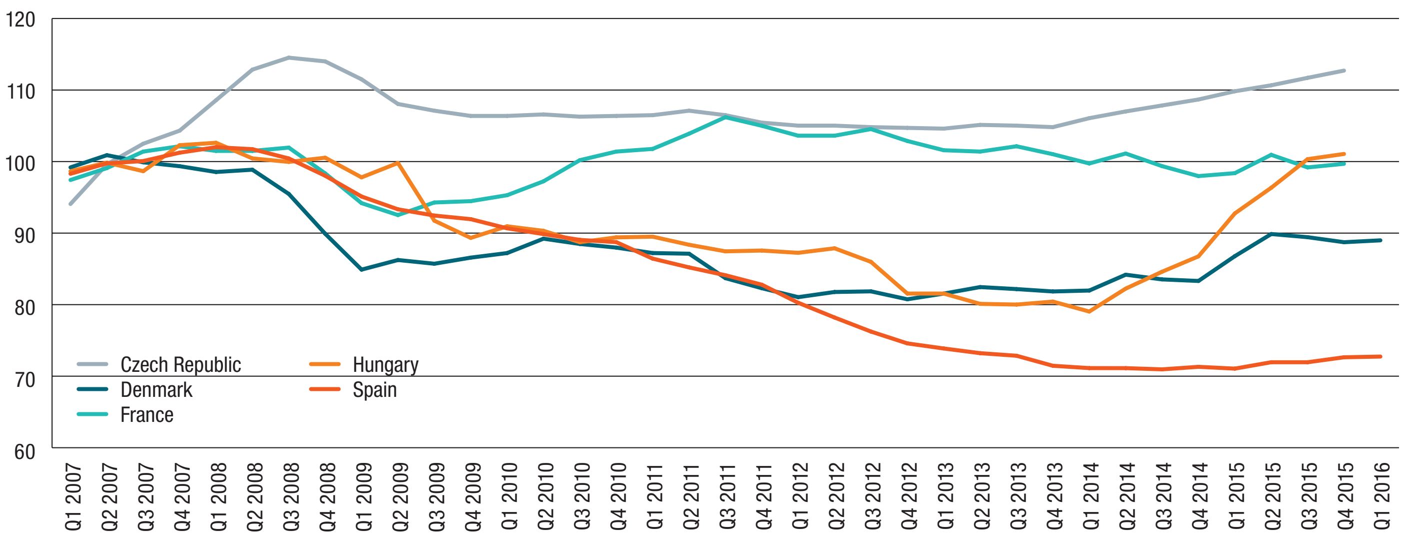
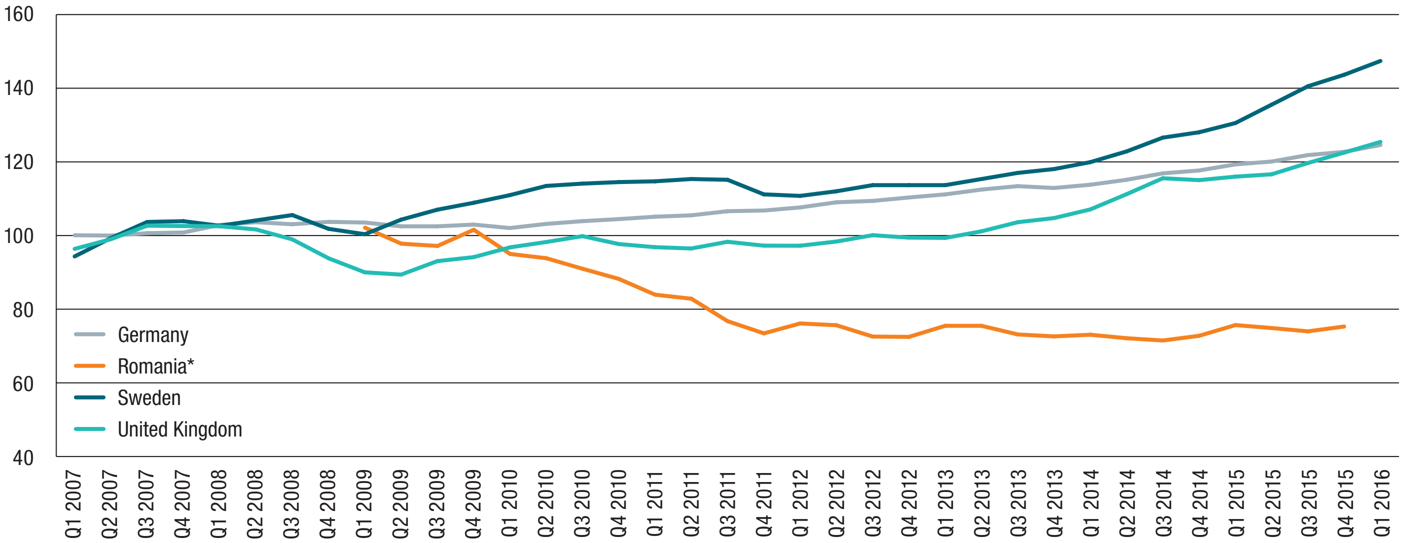


**Figure 6 ▶ Countries where house prices have risen by at least 1.5% over the latest quarter**




* 2010 = 100

# Danish Mortgages Explained – An Ecosystem of Transparency and Digitalisation

By Ane Arnth Jensen, Managing Director, Association of Danish Mortgage Banks

*In Denmark, transparency plays a key role in the housing and mortgage markets – including the market for covered bonds, where two-thirds of all outstanding lending is funded.*

In many places mortgage and housing markets are, to some degree, characterised by asymmetric information as one party has more or better information than the other. In Denmark, the mismatch of information is minimised due to an ecosystem of transparency and digitalisation.

The system involves home-buyers, real estate brokers, mortgage banks, investors and authorities. The high degree of transparency and digitalisation is part of the explanation for Denmark's high degree of mortgage financed home-ownership[9], mobility[10] and the extremely low – and in some cases negative – mortgage rates[11].

**HARD CORE PROPERTY FACTS**

All properties in Denmark are registered in a public data repository available online[12]. The register contains detailed information on age, size, building materials, renovations, utilities, trade information, etc. On top of that, real estate brokers are required by law to provide data in a standardised manner for all properties that are listed for sale. The Association of Danish Mortgage Banks also publishes a number of market statistics[13]. Among these, especially the Housing Market Statistic[14], serves as a useful tool for potential home-owners as it compares actual prices with listed prices.

Together with other available online information, it makes it easy for potential home-owners to access whether or not the asked prices are fair, because it can be compared with prices on similar properties, price history, differences in size, quality characteristics, etc. The information can also be used for potential buyers to bargain a lower price. If a property for sale has been on the market for a long period with significant price cuts, it indicates that the potential seller would be more willing to negotiate.

**INCENTIVES TO MAKE GREEN IMPROVEMENTS**

The high level of digitalised accessible information creates competition and gives sellers an incentive to invest in improvements that make the property more attractive. As the property is listed for sale, the seller has a possibility to supply three technical reports conducted by specialists on the property. One reports the current upkeep of the property and points out deficiencies which should be addressed. The second report attaches an energy efficiency grade to the property, and the third is a report on the electrical installations in the property. Combined with relatively high taxes on energy, this gives a potential seller an incentive to make green improvements to obtain a higher grade. In other words, it could be good business for a potential seller to invest in energy improvements that are not visible (e.g. insulation), because it is most likely it would result in a higher price.

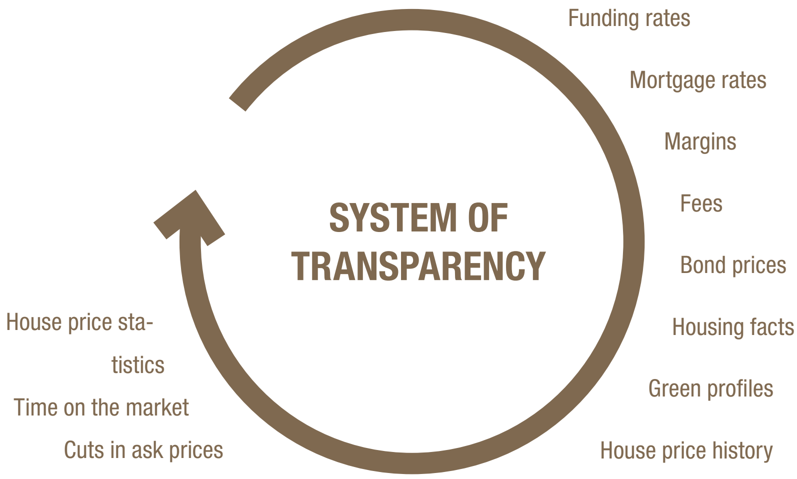
**MORTGAGE RATES AND FEES CAN BE COMPARED**

When buyers and sellers have found each other, and agreed on a price, the property typically has to be financed. The Association of Danish Mortgage Banks hosts a price comparison portal[15] showing mortgage rates, fees and margins on loans in all mortgage banks in Denmark offering residential loans. The rates are, to some degree, indicative, because the actual rates are market based as mortgage banks issue bonds to fund the mortgage loans. The bonds are then sold to investors at the prevailing market price. The borrower receives the proceeds from the bond sale and uses it to buy the property.

**COVERED BONDS ARE SOLD TRANSPARENTLY– ALL INFORMATION IS PUBLISHED**

Borrowers are certain that they will get a fair price on the bonds sold as there is full disclosure on post-trade information. In the new MiFIDII (Markets in Financial Instruments Directive) that comes into effect in January 2018, similar rules will apply for bond markets in other EU countries. In Denmark, all post-trade information has to be reported to the Danish stock exchange – also the many trades carried out over-the-counter. Most information is reported three minutes after the trades are closed.

**Diagram 1 ▶ Examples of information disclosed on the mortgage and housing market**




9 http://ec.europa.eu/eurostat/statistics-explained/index.php/Housing_conditions - Figure 2.

10 EU-dashboard, EU Commission, 2011.

11 EMF Mortgage.Info 06.2015 - How to Deal with Negative Mortgage Rates?

12 http://bbr.dk/

13 http://www.realkreditraadet.dk/Statistics.aspx

14 http://www.realkreditraadet.dk/Statistics/Prices_and_trades_of_owner_occupied_homes.aspx

15 http://www.realkreditraadet.dk/Statistikker/Prisguide.aspx

Information on big trades exceeding approximately EUR 14 million can be postponed to the end of the day. This option is only used for four out of ten times a big trade hits the market.

Borrowers can redeem their loans by having the mortgage bank buy back the same bonds issued when the loan was granted. The bonds can be bought back anytime also for refinancing purposes. Since the Danish covered bond market is highly liquid[16], borrowers can follow prices on the bonds funding their loans on a daily basis. If prices are lower than the initial price when sold, borrowers can cash-in the price difference. If prices are higher than the initial price, borrowers are protected by a price ceiling of par.

**MARGINS AND FUNDING COSTS ARE DISCLOSED**

The interest rate payments and repayments from the borrower are passed directly through to investors. Danish mortgage banks are merely intermediaries and require a fee from the borrower. The fees are denoted in percentage points and can be interpreted as mortgage banks' margins. This model of transparency creates competition: mortgages banks can compete on margins to attract customers who are certain to get the full benefit of changing market conditions due to the market-based principles with 100 per cent pass through.

**THE PROPERTY CHANGES HANDS DIGITALLY**

When a property has been sold and financed, deeds and loans are registered to the authorities through a digital application process. The public registration does not require any physical signatures, as the application is processed online. It only takes the authorities one day to process the applications – and for the property to officially have a new owner.

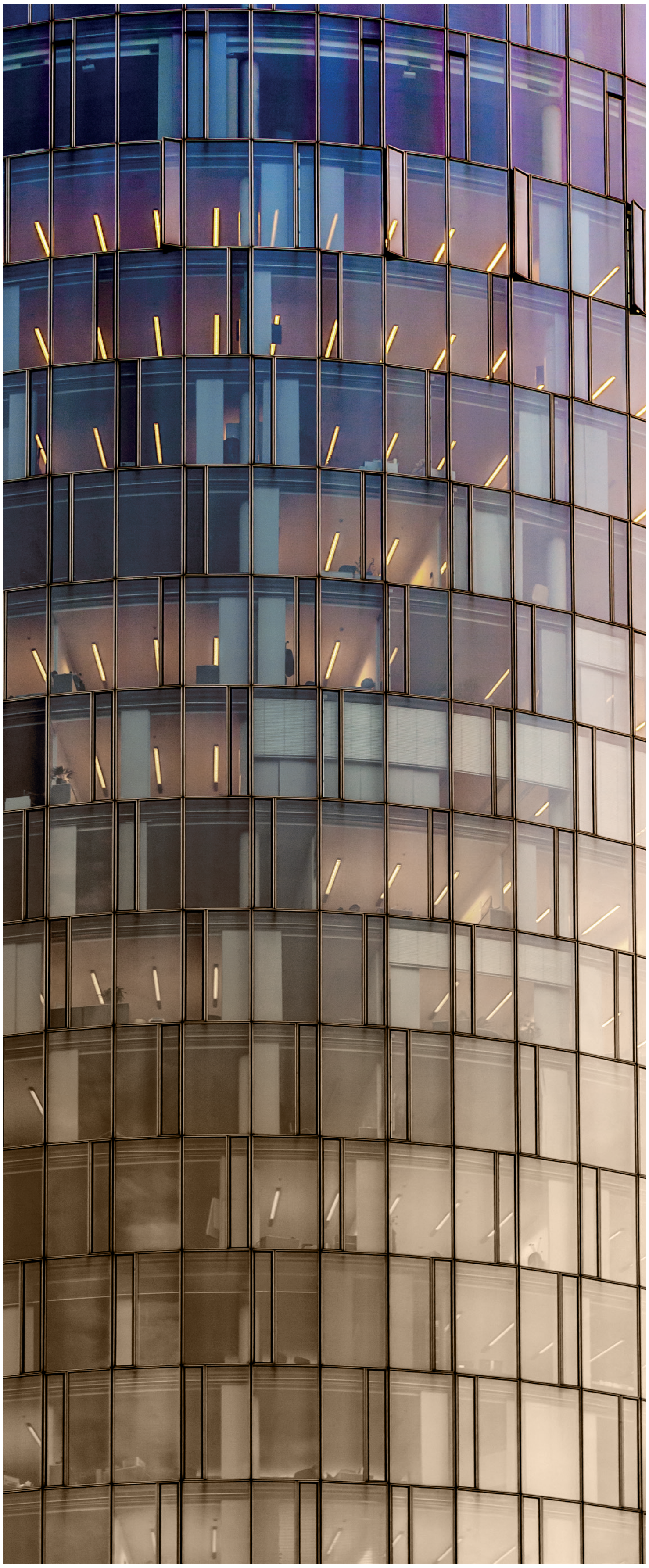
**TRANSPARENCY ENABLES GOOD STATISTICS TO MAKE INFORMED DECISIONS**

The ecosystem of transparency ends when all the information is aggregated into market statistics, many of which the Association of Danish Mortgage Banks publishes. This gives policy makers and analysts a good picture on variables like mortgages rates, the supply of credit, demand for housing, the green profiles on housing, etc.

In the same way that the high degree of transparency minimizes the costs of asymmetric information, the high quality of statistics enables policy makers to take informed decisions. For instance, analyses – partly made on mortgage data – have concluded that Danish households have robust finances and are resilient to an interest-rate hike or a prolonged period of unemployment[17]; previously it was a common perception that the high level of household debt made Danish households vulnerable.

On top of that, the Danish authorities have taken measures to counter risks. The measures include a supervisory diamond with five macro-prudential requirements governing mortgage banks, a requirement of a 5% down payment and guidelines to ensure sufficient caution is taken in the loan-granting process in metropolitan areas.

The Association of Danish Mortgage Banks will continue to work for as much transparency and digitalisation as is possible, because it reduces the cost of asymmetric information and strengthens competition both between sellers, mortgage banks and investors. In the end, it contributes to maintaining a model of cheap and flexible mortgages in Denmark.



16 Liquidity of Danish Government and Covered Bonds – Before, During and After the Financial Crisis – Preliminary Findings – Working Paper no 70, 2010, Nationalbanken (Danish central bank).

17 http://www.nationalbanken.dk/en/publications/themes/Pages/Household-wealth-and-debt.aspx

# Macro Prudential Instruments for the German Mortgage Market

By Prof. Dr. Michael Voigtländer, Cologne Institute for Economic Research

When it comes to banks, nowadays most voters and politicians predominantly think of the financial crisis. Thus, the main goal is to make banks more robust to prevent taxpayers from once again having the obligation of bailing-out banks from financial misery. Seemingly without alternative, more and more waves of regulation have emerged since 2008. Most important is the Capital Requirements Directive (CRD) IV, which sets rules to enforce more capital and which demands better liquidity management. Moreover, the Mortgage Credit Directive (MCD) has been implemented which sets incentives for more prudential lending by protecting borrowers from "irresponsible lending". Also, banks are for example affected by Solvency II and they have to pay special taxes as a consequence of the financial crisis. In Germany, the introduction of macro prudential instruments for mortgage lending is planned.

Until now the effects of all regulation projects are still uncertain. Most new rules are still in a period of introduction and although, in most cases, each rule can be justified, the outcome in practice is insecure. Especially, no one can estimate the outcome of the interplay of regulations as the financial system is very complex and innovative. As the robustness of banks is the focus, the logical view seems to be more regulations will result in more financially sound banks. However, banks play a very important role in promoting investment and growth in a country. Lending money to households and entrepreneurs is not only a means to make profits, but it is a necessity for modern economies to prosper. Therefore, there has to be a balance between the robustness of banks and their ability to lend. Unfortunately, this balance seems to be uneven and the newly planned macro prudential rules for mortgage lending are an example here.

According to the planned new legislation, banking supervision will be enabled to cap the loan-to-value ratio, debt-to-income ratio and debt-service-to-income ratio. Also, requirements for amortisation can be enforced. Such rules are used in a number of countries, like in the UK. However, Germany is a special market with a traditional prudential lending culture. In order to assess the impact on households, the Cologne Institute for Economic Research has analysed the Household Finance and Consumption survey provided by the European Central Banks. The analysis shows that in Germany, more households than expected have LTVs above 90%, but that these are predominantly households with higher wealth and higher incomes. Hence, the probability of credit defaults is low since high income groups are less often affected by over-indebtedness. What is more, most households have low debt-service-to-income (DSTI) ratios, 75% of all households with a mortgage have a ratio of less than 19%. In France, the corresponding value is 24%, in Spain it is 30%. The median DSTI for Germany is only 12% while it is 18% for France or 20% for Spain (see chart). In addition, only 1% of all households with mortgages have an LTV of more than 90% and a DSTI of more than 30%. Thus, risks for the financial system seem manageable.

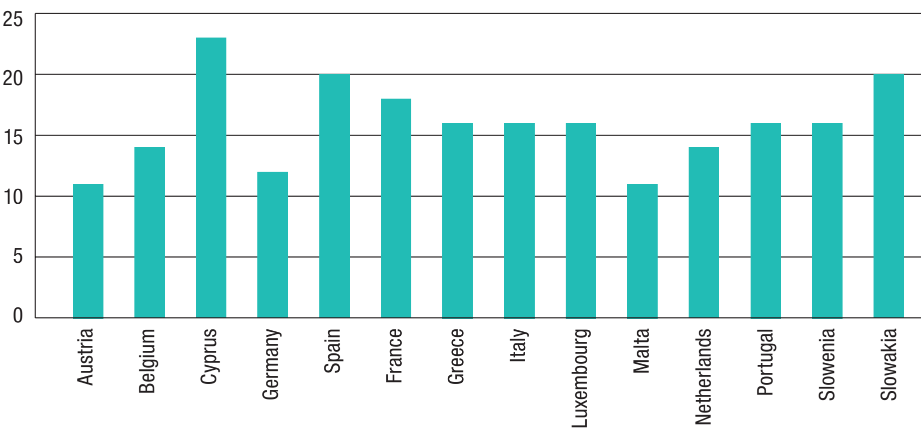
While the contribution of caps on mortgages on financial robustness seem minor, the effects on banks and customers are significant. First of all, such caps are a strong intervention in the principle of contractual freedom, which is an important device in a market economy. Households with less capital but high incomes are restrained from buying homes. Because of ultra-low mortgage rates, purchasing homes is superior to renting for almost all regions and cities, but with even more restrictions on lending only a small number of households can benefit from this advantage. At least, a good justification is needed for such a form of intervention. Secondly, restrictions on lending pose an additional burden on banks' profits given that low interest rate revenues on lending are small and mortgages are one of the more profitable business cases. Especially by demanding risk premia for higher LTV, the profitability increases. Of course, risks should be manageable, but the data proves that in most cases only households which are able to take higher LTVs have received such loans. By capping LTVs for all customers, banks are not only disempowered with regards to risk assessment, they also lose a source of profits. In this context it should be emphasized that profits do not only serve the interests of shareholders but are needed to build up the capital required under CRD IV. The Deutsche Bundesbank is worried about the profitability of German banks as this is the main source of building up capital. Consequently, the macro prudential instruments might even counteract the aim of financial robustness.

Finally, Germany has had a high current account surplus over a long period of time. German households save a lot of money which is not invested in Germany. As a consequence, other European countries are lenders, which results in more imbalances in the Eurozone. Hence, regulations which hinder domestic investment spur further imbalances.

It is without question that regulations are necessary in the banking system, but regulators should be more patient and analyse the outcome of regulations in greater detail. Before introducing even more rules, the effects of CRD IV or the MCD should be assessed. Hence, now is not the time to introduce macro prudential instruments for the German mortgage market.

**Figure ▶ DSTI in Europe - Comparison**

The median Debt-Service-to-income Ratio for households with a mortgage




*Source: HFCS – European Central Bank, Cologne Institute for Economic Research*


# NEWS IN BRIEF

## IVSC Invitation to Comment on Revised International Valuation Standards (IVS) 2017

On the 2nd of June 2016, the International Valuation Standards Council (IVSC) invited comments on a range of exposure draft documents which will form part of the Revised International Valuation Standards (IVS) 2017. The IVS is currently undergoing a significant revision and is scheduled to be published in 2017.

The exposure draft documents open for consultation are as follow:

- IVS 104 Bases of Value
- IVS 105 Valuation Approaches
- IVS 210 Intangible Assets
- Introduction and Framework for IVS 2017
- IVS 101 – Scope of Work, IVS 102 Investigation and Compliance and IVS 103 Reporting;
- IVS 200 – Businesses and Business Interests;
- IVS 300 – Plant and Equipment;
- IVS 400 – Real Property Interests;
- IVS 410 – Development Property; and,
- IVS 500 – Financial Instruments.

The deadline for comments on the first four documents listed above is the 7th of July 2016 and the deadline for comments on the remaining documents is the 31st of August 2016. All of these documents can be accessed via the IVSC website, here.

## EP Draft Report on Securitisation

On the 6th of June 2016, the European Parliament published a draft report on the proposal for a regulation of the European Parliament and of the Council laying down common rules on securitisation and creating a European framework for simple, transparent and standardised (STS) securitisation. This text aims at amending the proposal by the European Commission aiming to create common rules on securitisations and for a framework for SSTS securitisation. The European Commission's proposal has already been reviewed by the European Council, which published its general approach, i.e. its negotiating position, on the 7th of December 2015.

The STS proposal goes hand in hand with the regulatory works on the amendments to the Capital Requirements Regulation (CRR) for the capital treatment of securitisation.

The full draft Report of the European Parliament can be accessed here.

## EP Publishes Draft Report on Regulation on Prudential Requirements for Credit Institutions and Investment Firms

On the 6th of June 2016, the European Parliament published a draft report on the proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms. This text aims at amending the European Commission's proposal to modify the Capital Requirements Regulation (CRR) in order to revive the securitisation market. The proposal goes hand in hand with the regulatory works on the framework for the Simple, Transparent and Standardised (STS) securitisation.

The full European Parliament Report can be accessed here.

## EMF-ECBC Response to European Commission Consultation on an Effective Insolvency Framework in the EU

On the 16th of June 2016, the EMF-ECBC published its response to the European Commission's Consultation on an Effective Insolvency Framework in the EU.

The EMF-ECBC response can be accessed here.

## EBA Publishes Final Draft RTS on Risk Weights for Specialised Lending Exposures

On the 13th of June 2016, the European Banking Authority (EBA) published its final draft Regulatory Technical Standards (RTS) specifying how institutions should take into account and treat several factors when assigning risk weights to specialised lending exposures. The purpose of these RTS is to harmonise the assignment of risk weights to specialised lending exposures for institutions that apply the so called "supervisory slotting criteria" approach. These final draft RTS will be part of the Single Rulebook aimed at enhancing regulatory harmonisation in the banking sector in Europe.

These final draft RTS define four classes of specialised lending:
- project finance,
- real estate,
- object finance,
- and commodities finance.

For each of these four classes, a set of assessment criteria is specified by means of a list of factors that institutions shall take into account.

These factors are further detailed in sub-factors and some of those in sub-factor components. Institutions shall apply the approach set out in these draft RTS to combine the assignments of the factors to the categories in order to determine the final category and the risk weight to be attributed to the specialised lending exposure. This approach requires institutions to calculate the weighted average of the assignments of the factors to the categories, where institutions should determine the weights they assign to each factor, under certain strict conditions.

The approach followed in these RTS is in line with the current Basel framework, which uses the so-called "supervisory slotting criteria" approach under which specialised lending exposures are classified into categories depending on the underlying credit risk. These RTS have also taken into account the recent Basel proposals on constraints on the use of internal model approaches.

The full EBA RTS can be accessed here.

## EMF-ECBC Response to BCBS Consultative Document on "Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches"

On the 24th of June 2016, the EMF-ECBC published its response to the Basel Committee on Banking Supervision's (BCBS) Consultative Document on "Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches".

The EMF-ECBC response can be accessed here.

## EBA Publishes Fifth Annual Consumer Trends Report

On the 21st of June 2016, the European Banking Authority (EBA) published its fifth annual Consumer Trends Report, which provides an overview of the trends observed in 2016, the issues that will or could have an impact on consumers and other market participants and the areas where the EBA may take any action, if needed. The Report covers all the products that fall into the EBA's consumer protection mandate, such as mortgages, personal loans, deposits, payment accounts, payment services and electronic money.

For the 2016 Consumer Trends Report, the EBA used a wide range of different information sources and eight different consumer trends and related issues have emerged as relevant. Some of these had already been highlighted in last year's report, namely: household indebtedness, with a focus on lending and related practices, household borrowing and arrears handling, and creditworthiness assessment; banking fees and costs, looking at fees and charges on payment accounts, and their comparability, and at selected costs related to loans; selling practices related to the banking products, with issues related to cross-selling and sales incentives; innovations in payments; alternative financial services providers; and finally innovative uses of consumer data. The two new trends identified in this year's edition refer to foreign currency loans, especially mortgages; and to virtual currencies.

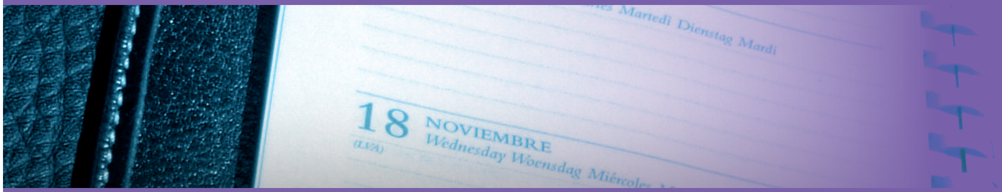
The EBA has already started to address some of these trends, and will use the findings of the report as input when developing and publishing its work programme for 2017 later in the year. Furthermore, Chapter 3 of the Report summarises how the EBA addressed the issues identified in last year's report. The measures taken include three sets of final Guidelines on creditworthiness assessments, on arrears and foreclosure, and on product oversight and governance, draft Guidelines on remuneration policies and practices for sales staff, as well as a Discussion Paper on the innovative use of consumer data.

The full EBA report can be accessed here.

## EMF-ECBC Response to European Commission's Targeted Consultation on the NSFR

On the 28th of June 2016, the EMF-ECBC published its response to the European Commission's targeted consultation on the Net Stable Funding Requirement (NSFR).

The EMF-ECBC response can be accessed here.




# AGENDA

## JULY 2016

**12/07** European Commission Conference on "Insolvency at crossroads – The way forward at EU level" – Brussels

**13/07** European Parliament Financial Services Forum (EPFSF) Event on Financial Education – Brussels

## AUGUST 2016

**25-26/08** Nordic Mortgage Council Annual Meeting – Oslo

## NEXT EDITION

The EMF-ECBC Secretariat would like to take this opportunity to wish all readers a very enjoyable summer break and to inform you that the next edition of ***Market Insights & Updates*** will be published at the end of August 2016.

ECBC
European Covered Bond Council

**SAVE THE DATE!**

**ECBC Plenary Meeting**
14 September 2016, Düsseldorf

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