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European Mortgage Federation Position Paper on the Leverage Ratio

The European Mortgage Federation¹ (EMF) is the voice of the European Union mortgage industry, and represents EU mortgage lenders, ranging from large universal banks (with important mortgage loan portfolios), to specialised lenders whose sole activity is to grant mortgage loans.

The introduction of a Leverage Ratio (LR) as a Pillar 1 requirement, and as described in the Basel III framework, is potentially of significant concern for mortgage lenders across the EU. The EMF, after having consulted with its membership, has prepared the present document, aimed at framing the issue of the LR from a mortgage lender's perspective, and at providing suggestions as to how this requirement can be made fairer and brought more in line with the EU's current priorities of jobs, growth and investment.

The mortgage and housing markets in Europe have always played a central role in the wider economy and in determining people's welfare and quality of life. As a matter of fact, efficient mortgage and housing markets improve social conditions and bring stability at the household level. This is achieved through responsible mortgage lending, which in Europe has allowed for affordable and sustainable access for EU citizens to home ownership. Moreover, activity in mortgage and housing markets encourages investment and fosters job creation in multiple sectors of the economy. Unsurprisingly, therefore, mortgage and housing markets are main drivers of the European economy, and directly affect most households across the Union, with around one in four European households currently holding a mortgage. Moreover, mortgage lending plays a key role in the financial sector of the EU as well. Homes and buildings are an important asset class, used by financial institutions as collateral to provide more funding through the issuance of covered bonds, thereby generating more lending and fuelling further activity in the economy. Setting an unnecessarily strict and arbitrary limit on this type of lending is primarily a danger for the health of the EU economy, and may well undermine its weak recovery at a time when it is most needed.

Current position of EU mortgage lenders with respect to the LR

1. According to the impact assessment carried out by the European Banking Authority (EBA)², EU banks' average LR ranges from 3.1% to 3.9%, depending on which treatment of Securities Financing Transactions (SFTs) under the Capital Requirements Regulation³ (CRR) is adopted, and on bank size. It is suggested that, on average, EU banks would be able to fulfil a 3% LR, though they would, on average, need to raise significant amounts of capital to be able to fulfil a higher LR, for example of 4%.
2. It is important to note, however, that these averages mask - and in fact potentially do not even take into account - some large differences observed for specialised mortgage lenders, as well as for lenders whose portfolios are heavily biased towards mortgage lending. The LR for these banks is, in some instances, considerably below even the 3% threshold (see Box 2). These institutions' LR is lower than universal banks' due to the fact that mortgage lending is a low risk activity, and therefore, mortgage lenders can set aside lower proportions of capital for prudential and capital requirements purposes.

¹ Established in 1967, the **European Mortgage Federation (EMF)** is the voice of the European mortgage industry, representing the interests of mortgage lenders and covered bond issuers at European level. The EMF provides data and information on European mortgage markets, which were worth over €6.7 trillion at the end of 2013. As of April 2015, the EMF has 18 members across 14 EU Member States as well as a number of observer members. The EMF-ECBC is registered in the EU Transparency Register under ID Number 24967486965-09.

² <https://www.eba.europa.eu/regulation-and-policy/leverage-ratio>

³ http://ec.europa.eu/finance/bank/regcapital/legislation-in-force/index_en.htm

3. This point is even more relevant for credit institutions in countries with systems of public guarantees for mortgage loans e.g. in France and the Netherlands. These systems logically involve a transfer of part or all of the risk from the credit institution to the loan guarantor, which basically underwrites loans against default. In this way, the lender can charge a lower interest rate on the loan and further reduce the amount of capital it must hold on its balance sheet to correspond to the lower risk level. In countries where these systems are prevalent, because the loans remain on balance sheet, the impression is given that credit institutions that avail themselves of these schemes are even more under-capitalised with respect to their leverage, whereas of course this is due to the lower risk of these assets.
4. In addition to the above, and in the context of the Basel III LR proposed requirement of 3%⁴, it is important to highlight the difference between EU banks and other international banks, (particularly American ones) for which Basel III is designed. In terms of mortgage lending, an important characteristic of EU banks is the fact that loans mainly remain on the lenders' balance sheets, whereas in other markets, notably in the United States (US), mortgage lending is in large part removed from lenders' balance sheets by way of securitisation ("originate to distribute" model), and US mortgage lenders have access to Fannie Mae and Freddie Mac to free up their balance sheets. In addition, most public sector funding in the US is channelled via bond markets rather than intermediated by banks as in the EU. This means that balance sheets in the US are much smaller than in the EU. This on-balance characteristic also entails a relative penalisation of "originate to hold" models vis-à-vis "originate to distribute" models. This means that the 3% threshold proposed by Basel, which is aimed at the international community, may be too strict for the EU market. Moreover, whereas Basel III is designed for large and systemically important universal banks, EU regulation is applicable to all financial institutions, including specialised lenders, for which Basel III does not cater. The EMF would like to stress the extent to which these differences potentially raise concerns about an un-level playing field between the EU and US, and the impact this could have on EU banks' competitiveness.
5. The EMF recognises that the 2014 revisions to the Basel III Leverage Ratio Framework and Disclosure Requirements published on the 12th of January 2014 provide relief for certain exposures, such as derivatives and repurchase agreements, which constitute a significant part of banks' balance sheets, and, in this way, makes it easier for large universal banks to meet the ratio. However, the EMF would like to stress that these revisions do not provide much relief to specialist mortgage lenders, whose balance sheets are, as outlined above, composed entirely or substantially of on-balance mortgage loans.

Why the currently-proposed LR is inappropriate for application to EU mortgage lenders

6. The CRR specifies the LR's objective as the following: "first to limit the risk of excessive leverage by constraining the building up of leverage in the banking sector and second to act as a backstop to risk-based capital requirements." The ultimate aim of the LR is to improve the EU's financial stability.
7. The main concern with the proposed LR is that it treats all assets equally in the calculation of the exposure measure (denominator), whereas their respective potential negative impact on financial stability is not equal.
8. An example of this is the clear difference, in terms of the nature of the assets, between mortgage lending and other assets (unsecured lending, etc.). In the case of the former, the loan is backed by immovable property, the value of which does not fluctuate as sharply, or as quickly as other purely financial (non-physical) goods (please see Annex I for a comparison of house price fluctuations with

⁴ <http://www.bis.org/publ/bcbs270.htm>

stock market fluctuations in the largest EU economies, as an example of this concept). This implies that in terms of volatility, mortgage-generated leverage is much less of a threat to financial stability than leverage generated by other assets (e.g. unsecured lending).

9. The EMF would like to take this opportunity to underline that it acknowledges the fact that the LR is intended as a non-risk-based backstop to existing risk-based capital requirements. The EMF's proposal is entirely compatible with this design, as it is not based on a risk assessment approach (even though mortgage lending does pose considerably lower risk vis-à-vis other assets), but rather addresses the other key reasons why the LR in its current form would not be an appropriate requirement for the achievement of financial stability in the EU – these are discussed in more detail in the following paragraphs.
10. In order to better understand how an inappropriately-calibrated LR would affect mortgage lenders, and in turn the EU financial system and economy, the following should be considered: a mortgage lender which faces a shortfall in its LR could react to this by taking one of the following measures:
 - a) Restructuring
 - b) Deleveraging
 - c) Raising capital
11. Any one of these options could have a potentially negative impact on EU financial stability and economic recovery, including job creation and growth potential, in the following ways:
 - a) Restructuring – Changing the nature of activities, potentially by cutting business lines, could be an option for some (universal) banks. Due to the low-risk nature of mortgage lending, and the subsequent low margins, banks could be incentivised to use their 'leverage allowance' to engage in riskier (and potentially more profitable) lending activities. In this way, the credit institution might very well achieve a specific leverage ratio, but this would raise the overall level of risk in the EU financial sector, as institutions which did not, in the past, engage in risky activities would be forced into them by means of regulatory requirements. In addition, some specialised banks may not be able to change their portfolios so easily, and may therefore have to resort to other solutions, which may potentially have equally undesirable effects.
 - b) Heavy mortgage deleveraging – one such solution would be to cut mortgage lending drastically in order to reduce the denominator and fulfil the regulatory requirement. The possible negative consequences of this are manifold. First, for a low-margin business such as mortgage lending, this would force the lender to transfer the costs onto borrowers. This would reduce the relative competitiveness of specialised lenders, and may result in their business becoming non-viable. However, the most significant consequence by far is the subsequent reduction in mortgage lending to the economy. This goes against the wider objective of EU institutions to increase the availability of credit; this would also affect SMEs through the lower availability and higher cost of mortgage loans for commercial purposes, for instance. Moreover, such changes may cause significant distortions in the mortgage lending market, which is at the core of the EU economy, as its value is around 6.7 trillion EUR, or 51% of the EU 28 GDP (2013 data). Importantly, this would have a negative impact on job creation in the housing, construction and related sectors, as well as potentially significant negative impacts on both potential and effective growth. All in all, these consequences would undermine not only the purpose of the LR (i.e. to increase financial stability and resilience), but would also work against some of the current core priorities for the EU (i.e. jobs creation and economic growth)⁵.

⁵ http://ec.europa.eu/priorities/work-programme/index_en.htm

- c) Raising capital – an alternative way in which the LR could be fulfilled is by increasing the amount of Tier 1 Capital⁶, which is the numerator of the LR. Assuming this is a viable option, which is not necessarily the case, particularly for lenders with small margins, it would undoubtedly represent a substantial cost for mortgage lenders. This cost would have to be met in some way, and in all likelihood, it would result in it being transferred to both residential and commercial mortgage borrowers through higher interest rates, limiting access to credit or increasing repayments. The potential results are, as outlined above, likely to negatively impact jobs and growth due to the central role played by the mortgage and housing markets in the EU economy.

Box 1: Simulation of the impact of a 3 % and 4 % Leverage Ratio on a model specialised mortgage lender

We try to assess the impact of a LR on a specialised mortgage lender, by looking at a simple numerical example that however effectively shows the impact of a Leverage Ratio of 3% and 4% on a specialised lender with a current LR level slightly below the 3% mark.

Initial assets (mortgage loans) = 100

Initial capital = 2.5

Leverage ratio = 2.5%

Case 1: Leverage Ratio requirement of 3 %

Option a: Raise capital: 0.5 in capital needs to be raised, i.e. **20 %** of the current holdings.

Option b: Reduce assets: **16.7 %** of outstanding mortgage loans will have to be cut.

Case 2: Leverage Ratio requirement of 4 %

Option a: Raise capital: 1.5 in capital needs to be raised, i.e. **60 %** of the current holdings.

Option b: Reduce assets: **37.5 %** of outstanding mortgage loans will have to be cut.

In summary, the main messages are the following:

- Specialised lenders would likely have to adjust their business significantly in order to fulfil even a 3% LR, unless appropriate weights are conceded for mortgage loans.
- The difference in impact between a 3% and 4% LR is very large: regulators should be aware that a floor any higher than 3% would severely impact specialised lenders' core activities, and by extension the provision of mortgage lending in countries where this business model is prevalent.

Possible solutions

12. A number of steps could be taken to reduce, or altogether eliminate, the potential for the LR to negatively affect EU financial stability through its impact on mortgage lenders.
13. The CRR clearly recognises the fact that, in the EU, the existence of specialised (mortgage) lenders justifies different treatment in terms of LR based on "business models" (Point 95 of the Recital). In this sense, EU lenders would be 'classified' into different categories, each of which would have to fulfil a different LR threshold. There are a number of reasons why, although correct in theory, this would be a sub-optimal solution in practice:
- a) It is practically very difficult to express a fair judgement as to which lender should be allocated to which category.
 - b) Whichever definition of business model is used, there would be a level playing field issue for other institutions engaged in mortgage lending.

⁶ It is worth noting that, where a leverage ratio has already been introduced, it is sometimes the case (such as in the UK) that there are restriction as to the amount of Additional Tier 1 Capital that may be used for the purpose of fulfilling the LR. In such cases, lenders must rely on CET1, which makes the requirement even more restrictive.

- c) Negative impacts outlined in point 9 would still apply to some extent, as the relative capital requirements impact of mortgage loans vis-à-vis other assets in LR terms would still be disadvantageous, especially for those institutions that would not qualify for a more lenient treatment according to their “business model”.

14. In light of this, a much more effective and fairer solution would be the adoption of a portfolio approach. Based on this, mortgage loans should be assigned a weight of value less than 1, thereby reducing the impact of a large mortgage portfolio on the institution's LR. It is important to stress that such weight is not to be justified on the basis that mortgage lending is a comparatively low-risk activity (which is the case), rather by the idea that such a LR would become a barrier for mortgage lenders to carry out their normal lending activities, with the negative consequences on job creation and economic growth that are outlined above. Moreover, a portfolio approach based on these principles results in a fair treatment across institutions, as any adjustment would be applied depending on the effective size of the mortgage portfolio. The EMF is also keen to actively engage with policy-makers with a view to determining the best possible way of practically implementing the “business model” differentiation, but stresses the importance of any such method ultimately achieving the above-mentioned results.
15. The EMF would like to express its concern as regards the place of the LR within the wider financial regulatory landscape, and its effectiveness in achieving its primary objective of increased financial stability and resilience in its current form. A possible alternative to the way the LR is currently designed would be to include a leverage element within the CRR Pillar 2 framework instead of Pillar 1. This would ensure a correct assessment of the true level of capital the institution needs to hold against its leverage depending on its specificities and portfolio, and would not pose the threat of unduly restricting mortgage lending.

Box 2: Interaction of Leverage Ratio requirement with Capital Floors

Under the CRR, financial institutions are required to fulfil Capital Floors at all times. This is binding until at least 2017. There are two ways to calculate Capital Floor requirements: (i) using the Basel I risk weights or (ii) using the SA risk weights. In the case of pure residential mortgage lending, risk weights under Basel I are 50%, and under the SA, 35% (for most mortgages). The Capital Floor requires banks to hold capital enough to fulfil capital requirements on 80% of their risk-weighted assets. This implies the following:

Example for a lender specialised *exclusively* in residential lending (n.b. specialised mortgage lenders have other exposures too):

Under Basel I risk-weights:

- For a bank with a balance sheet of 100, the capital floor risk-weighted assets will be 40 (i.e. $100 \times 0.8 \times 0.5$)
- Tier 1 minimum capital requirements are 6%, implying capital holdings of 2.4 for the above case (0.06×40)
- On top of this, banks will need to hold a capital conservation buffer of 2.5%, implying additional CET1 capital holdings of around 1 for the above-mentioned example
- The total capital holdings would then be 3.4
- This implies a Leverage Ratio of 3.4%

Under SA risk-weights:

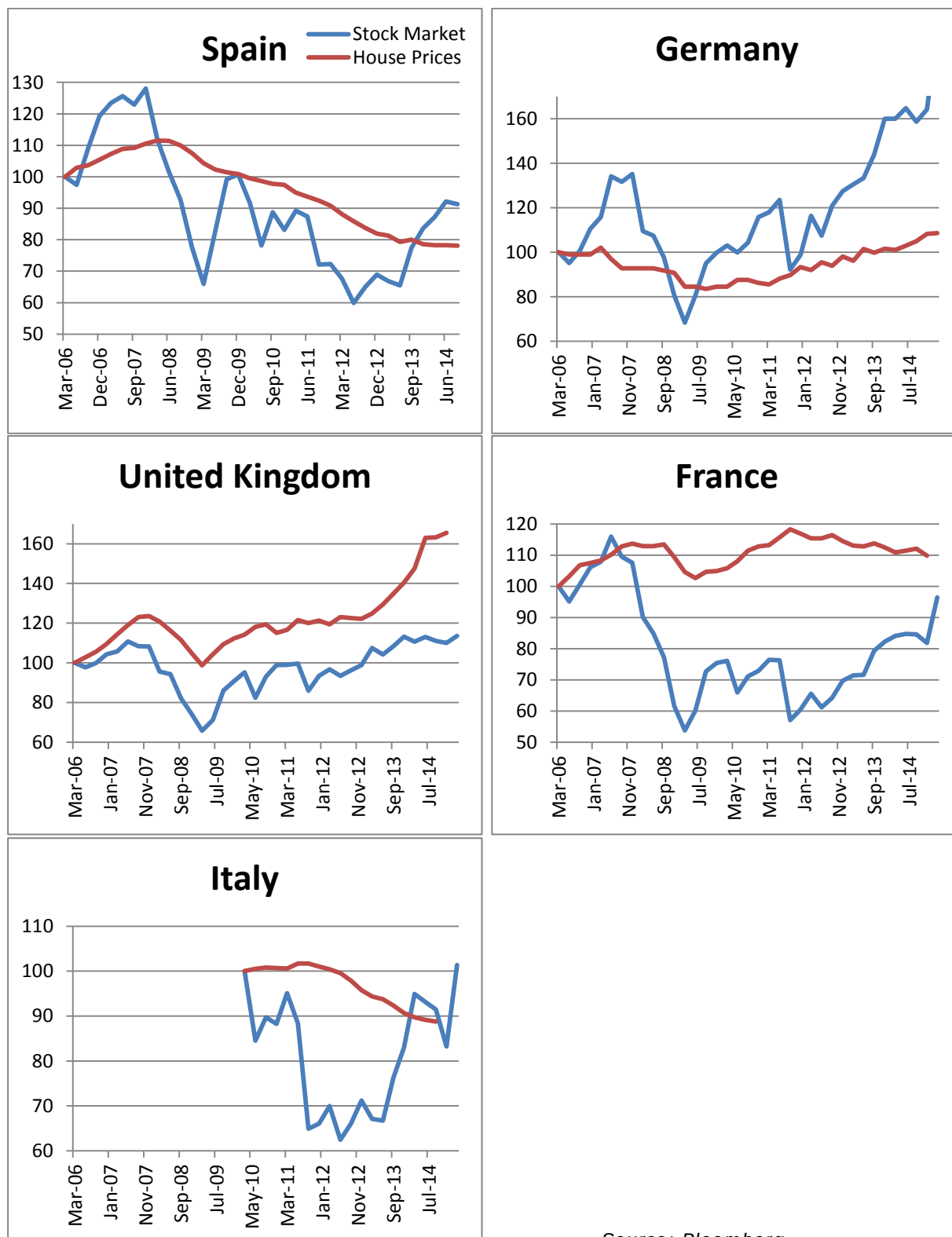
- For a bank with a balance sheet of 100, the capital floor risk-weighted assets will be 28 (i.e. $100 \times 0.8 \times 0.35$)
- Tier 1 minimum capital requirements are 6%, implying capital holdings of 1.68 for the above case (0.06×28)
- On top of this, banks will need to hold a capital conservation buffer of 2.5%, implying additional CET1 capital holdings of around 0.7 for the above-mentioned example
- The total capital holdings would then be 2.38
- This implies a Leverage Ratio of 2.38%

It is therefore the case in the simplified example above that, given that pure residential mortgage banks fulfil Capital Floors and the capital conservation buffer (under capital floor risk-weights), they would automatically fulfil a 3% Leverage Ratio, given Basel I risk-weights (the 'stricter' of the two). However, there are two important points here that should be noted:

- **The above does not consider the fact that most specialised lenders (including mortgage lenders) also have other assets that are assigned an even lower risk-weight under Basel I (e.g. public lending), that therefore lower the required capital floor, and, in turn, the required capital holdings. This means that it is not necessarily the case that specialised mortgage lenders automatically fulfil a 3% Leverage Ratio by fulfilling Capital Floors and buffers.**
- **If the SA (or even IRB) is used instead of the Basel I risk-weights, the implied level of the Leverage Ratio would actually be of up to 2.38% (in case of a pure residential mortgage lender). This would therefore not be sufficient to even fulfil the 3% level. Moreover, the outdated nature of the Basel I risk-weights may mean that the SA becomes increasingly widespread in the calculation of the Capital Floors.**

Annex I

House prices (referring to physical goods) normally exhibit a significantly lower level of volatility than stock market prices (representing financial, non-tangible goods). Therefore housing-backed assets are more stable than other kinds of assets (particularly in the short-run).



Source: Bloomberg