

European Mortgage Federation-European Covered Bond Council (EMF-ECBC)

Paper on Implementing the Final Basel III Reforms in the EU

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The European Mortgage Federation-European Covered Bond Council (EMF-ECBC) is pleased to provide herewith its views on the forthcoming implementation of the Basel III Framework into EU legislation. This paper focuses on the Framework's systemic impact on real estate finance in the EU and should be considered as a complement to the EMF-ECBC Response to the European Commission Consultation on the same subject.

The EMF-ECBC acknowledges the overall objective of the Basel III framework to ensure a resilient banking system which in turn supports the real economy through the economic cycle. The EMF-ECBC further acknowledges the most recent reforms intended to ensure credibility in the calculation of risk-weighted assets (RWAs) and improve the comparability of banks' capital ratios.

In this Note, we highlight the fundamental role of the mortgage business in financing the real economy and of the covered bond asset class in supporting critical functions of the issuing institutions and fostering financial stability. Our assessment concludes that certain components of the new Basel III rules, the output floor in particular, would significantly hamper the ability of the mortgage and covered bond industries to deliver on these and seriously threaten the traditional European business model of on-balance and long-term mortgage lending.

To briefly recall our position on the output floor, it is our assessment that the calculation of the output floor must be restricted to the capital components listed by the Basel Accord, i.e. exclude buffer requirements for other systemically important institutions, for systemic risk and for Pillar 2. Otherwise, the output floor would not act as a backstop affecting only outlier banks as intended by the Basel Committee. We propose that, if the output floor is included in the EU financial legislation, it should be implemented as one of three parallel capital requirements, alongside the risk-based requirement applying RWA calculated using approved internal models and standardised approaches as applicable and the leverage ratio requirement. All three capital requirements should be assessed. The most constraining capital requirement (the requirement that results in the highest own fund requirement) will be decisive for the risk sensitivity of the capital requirement framework for the bank.

Key Observations

Funding of the Real Economy & Financial Stability

1. EU mortgage markets are fundamental to the EU economy. At the end of 2018, the volume of outstanding mortgage loans in the EU amounted to €7 trillion, equal to almost 50% of EU GDP¹. Mortgage markets provide access to housing finance for the EU's citizens, promoting welfare and stability at the household level, and encourage investment and foster job creation in multiple sectors of the economy.
2. Mortgage lending plays a key role in the financial sector of the EU. 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.
3. It is important to recall that mortgage lending is recognised as a low risk activity, for which mortgage lenders are permitted to set aside lower proportions of capital for prudential and capital requirement purposes. According to the EBA quantitative impact assessment however, it is mortgage banks that will experience the highest increase in capital

¹ Data taken from Hypostat 2018, www.hypo.org

requirements (20%-25%) for which the output floor will be the single most important driver of the impact. This higher capitalisation will in turn increase the cost for European borrowers in the form of higher lending rates and fees.

4. Indeed, it is widely recognised that the application of the 'full' output floor across all capital components of Pillars 1 and 2 would result in a significant increase in the capital requirements resulting not only from Pillar 1, but also from the buffers and the SREP add-ons (Pillar 2). This effect does not reflect any evidence that capital increases for mortgage lenders of such a size might be justified from a risk perspective.
5. The result of this would be a severe loss of risk-sensitivity in the capital requirements for a wide section of European IRB banks and a substantial increase in capital requirements for the core lending activity of low-risk European mortgage lenders, impacting on lenders' ability to finance the real economy. This also increases incentives for high-risk lending and puts upward pressure on the cost of mortgage lending for both households and corporates.
6. Pressure placed on the asset side of the balance sheet, i.e. on mortgage lending activities, has repercussions for the liabilities side of the balance sheet, in this case, the covered bond asset class, which is typically backed by mortgage or public sector loans. During the last financial crisis, the covered bond asset class confirmed its key role as a crisis management tool able to ensure investor confidence, long-term financing and overall financial stability. But the output floor as currently calibrated threatens the covered bond-based business model of European mortgage lenders whilst the purpose of the recent covered bond harmonisation initiative of the European Commission was the contrary, i.e. the strengthening of the covered bond product.
7. Ironically given their overall objectives, the Basel Reforms tend to favour short-termism. Non risk-sensitive or floored capital requirements challenge lenders who want to keep long term mortgage exposures on their balance sheets. As a consequence, the output floor directly counteracts the overall goal of the EU's financial services policy to strengthen and expand long-term finance as one of the fundamental pillars of financial stability.
8. It is worthwhile to underline that the traditional European way of financing real estate is based on long term on-balance mortgages. This business model tightens the long-term relationship of lenders with their customers in line with the responsible lending principles of the European Union. Consumer trust built over the longer term is another pillar for stable financial markets.
9. Referring to the recent introduction of a common framework for the issue of covered bonds and covered bond public supervision in the European Union (Directive (EU) 2019/2162), we also emphasise the systemic correlation between covered bond funding and on-balance mortgage lending. A modelling of the output floor disrespecting European finance techniques would significantly harm the purpose of the covered bond harmonisation and weaken covered bonds as a crisis resilient funding instrument.
10. Non risk sensitive capital consumption embedded in the new Basel framework raises concerns regarding the possibility of securing stable funding sources over the longer term for all European mortgage markets, opening the door to less stable sources of funding. We are also concerned about level playing field issues at European and global levels where capital providers outside of the banking industry provide mortgage loans without being subject to the same supervisory requirements as credit institutions in the European Union.
11. One of the primary objectives of the final Basel Reforms, and the output floor in particular, is to mitigate perceived variability in internal modelling. We recognise this but refer to an EBA and a BIS study broadly confirming that: 1) variance in prospective losses in IRB are mainly determined by actual differences in quality of portfolios and 2) IRB models have tended to be conservative rather than optimistic in their outputs.
12. With these considerations in mind, we are strongly supportive of ongoing efforts to ensure quality of internal models and would point to the ECB's TRIM exercise in this respect. At the very least, these studies reinforce the Industry's call for a future output floor to be limited to the internationally applicable Basel capital requirements.

13. As a final consideration here, we would strongly encourage policymakers to ensure that in implementing the final Basel III Reforms, there is a level playing field between the EU and other global jurisdictions in order to safeguard the competitiveness of the EU banking sector.

Cumulative Impact of Other Prudential Measures

14. The impact of the implementation of the final Basel III Reforms should not be seen in isolation. These final Reforms mark the end of a long series of policy interventions, the cumulative impact of which should be assessed and carefully considered.
15. The 2010 Reforms already introduced a non-risk-based backstop to capital requirements in the form of the leverage ratio intended to prevent excessively low capital levels. However, the leverage ratio primarily penalises the low risk, low margin mortgage business model. As regards residential mortgages and irrespective their IRBA risk weights, a leverage ratio of 3% translates into an approximate risk weight of 37% of these exposures thus widely restraining possible internal models' variability. In our view, the objectives of the leverage ratio and the output floor are overlapping here, making the output floor redundant.
16. The 2010 Reforms furthermore introduced measures to improve banks' liquidity: the Liquidity Coverage Ratio and the Net Stable Funding Ratio (NSFR). The NSFR is intended to ensure a better alignment of bank assets and liabilities. However, it results in two biases:
- Firstly, it favours deposits over capital market-based funding. Indeed, deposits are assigned more favourable factors than covered bonds, suggesting short term deposits are a more stable source of funding than longer dated bonds, which is debatable and may foster a practical overreliance on deposits.
 - Secondly, the NSFR favours unsecured over secured debt within capital market-based funding instruments. Due to the encumbrance "penalty" assigned to mortgages in the cover pool and the reduction of the ASF ratio of covered bonds with maturities lower than 1-year, identical assets still receive a better weighting if backed by unsecured debt than if backed by a covered bond. Hence, it is not possible to fund a mortgage cover pool through covered bonds only. This not only goes against the principle of a level playing field, as it penalises covered bond (and other secured funding like securitisation) issuers, but it also incentivises a shift towards shorter dated and more expensive unsecured funding. Experience has shown that senior debt dries out in a crisis, unlike covered bonds which persist.
17. Taking the leverage ratio, the NSFR and the final Basel Reforms, in particular the output floor, together and their cumulative impact, these measures heavily penalise the mortgage lending and covered bond businesses as a result of their intrinsic natures i.e. low risk, long-term and on-balance finance, putting further pressure on the ability of mortgage lenders to finance the real economy and undermining the role of the covered bond asset class as a robust, tried and tested long term funding instrument.

Sustainable Finance

18. Reflecting the strong commitment of the mortgage industry to support the clean energy transition, since 2015, the EMF-ECBC, has been leading on an [Energy Efficient Mortgages Initiative](#) (EEMI) to incentivise and channel private capital through the mortgage product, into energy efficiency investment in buildings. Indeed, energy efficiency in particular has been identified as one of the key drivers of the decarbonisation process and buildings are recognised as the largest consumers of energy in the Union. At the time of writing, 55 lending institutions, which represented over 55% of mortgages outstanding in the European Union equal to more than 25% of EU GDP at the end of 2018, are committed to the EEMI. Significantly, the EEMI will also drive an important value chain by delivering energy efficient mortgage assets which can be pooled for the purposes of 'energy efficient covered bond' funding, further scaling up investment.
19. This Initiative is extremely relevant in the context of the EU's ambition to be the first climate neutral bloc in the world by 2050 and its focus on unlocking private finance to support this transition. The financial sector has been recognised as being fundamental to the transition to a climate-neutral economy and accordingly the European Commission is putting sustainable finance at the heart of the financial system.

20. With these considerations in mind, non risk-sensitive capital consumption driven by backstops such as an output floor of 72,5% has the potential to jeopardise the transformative role of mortgage lenders in relation to climate change and the attainment of the 2050 emission targets. More specifically, unjustified increases in the capital requirements of European mortgage lenders will directly hamper their ability to finance the renovation of the EU's building stock, 35% of which is over 50 years old and almost 75% of which is energy inefficient.

Concluding Remarks

21. The mortgage business plays a fundamental role in financing the real economy, while the covered bond asset class supports critical functions of issuing institutions and fosters financial stability.
22. Certain components of the new Basel III rules, the output floor in particular, would significantly hamper the ability of the mortgage and covered bond industries to deliver on these and seriously threaten the traditional European business model of on-balance and long-term mortgage lending.
23. Furthermore, the impact of the implementation of the final Basel III Reforms should not be seen in isolation. These final Reforms mark the end of a long series of policy interventions, the cumulative impact of which should be assessed and carefully considered.
24. Finally, in a context where the financial sector has been recognised as being fundamental to the transition to a climate-neutral economy, non risk-sensitive capital consumption driven by backstops such as an output floor of 72,5% has the potential to jeopardise the transformative role of mortgage lenders in particular in relation to climate change and the attainment of the 2050 emission targets