

Final European Mortgage Federation-European Covered Bond Council (EMF-ECBC) Policy Paper on EC Proposal for an amended CRR implementing Basel III

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In the current crisis context, more than ever, the housing sector is key to the EU achieving its goal of reducing greenhouse gas emissions and energy dependency over a medium to short-term horizon.

Housing is a strategic sector not only because homes are the main place where people spend their lives and, increasingly, work, but also because buildings account for 40% of CO₂ emissions in continental Europe. In a context where more than 220 million homes in Europe need to be renovated to meet our 2030 targets, this equates to renovation at a rate of in excess of 100,000 homes per day, or more than half a million per week. The scale of the investment needed to meet this challenge is huge and cannot be achieved by the public sector alone. Today, the EU's mortgage markets are equivalent to almost 50% of the EU's GDP and therefore have a central role to play in this regard. The real breakthrough of a net-zero Europe will come through the large-scale use of green mortgages, as highlighted by the Energy Efficient Mortgages Initiative (EEMI), which seeks to introduce a greener, sustainability-focused approach to purchasing, renovating and living in homes by way of an 'ecosystem' aligning the interests of lenders, investors, SMEs, utilities and, above all, consumers.

In light of the tangible risk for stagflation, mortgage lending needs to be strategically oriented towards fostering GDP growth and job creation, as well as to defending consumers' disposable income and purchasing power from inflationary trends linked to energy prices. It is therefore of paramount importance to consider the knock-on effects of the Basel III implementation on the housing and energy sectors as well as on the investments needed to support the Next Generation EU, the EU Green Deal and RePowerEU.

With these key issues at stake, the implementation of Basel requires a proportionate approach to the treatment of mortgages. This is particularly valid for the principle of risk-sensitivity which is considerably challenged by the Output Floor (OF). From a systemic perspective, it could furthermore represent a threat to the on-balance sheet nature of the EU mortgage business, including the viability of covered bonds, which provide crucial anticyclical long-term access to global capital markets.

Against this background, we would draw your attention to the following specific considerations based on the results of a recent Copenhagen Economics Report, commissioned by the EMF-ECBC, on the impact of the Basel III Implementation on the EU's mortgage markets¹. These are then followed by a series of Industry priorities for action:

- **The output floor (OF) of 72,5% proves to be particularly detrimental for mortgage markets**
 - Whereas the overall CRR-package triggers an average capital increase for the entire banking sector of 6-8%, there is strong evidence that mortgage lending is considerably more impacted: the average additional capital needs for mortgage portfolios are expected to increase by 18%.
 - The main driver for such an incommensurate capital increase is the output floor of 72.5%. Around two-thirds of IRB exposures in the mortgage market of the European Union are bound by the output floor.

¹ Copenhagen Economics. (2022) Impact of Final Basel III on the EU Mortgage Sector (<https://hypo.org/app/uploads/sites/3/2022/05/Impact-of-Final-Basel-III-Final-Report-Copenhagen-Economics-May-2022.pdf>).

Note: The authors assessed the impact of the Banking Package 2021 on 80 of the largest credit institutions in 13 major mortgage markets in the EU. The country selection covers 93% of the total EU mortgage market.

- An 18% capital increase is almost 2 times higher than the average weighted capital increase triggered by all other banking assets. It is furthermore far beyond the initial target ratio. At the beginning of the process, the G-20 mandate provided guidance that Basel III shall not result in significant capital increases across the banking sector (below 10% additional capital).
- An important share of banks' balance sheets is affected: the 18% increase applies to 28% of the total EU credit assets (outstanding mortgage loans in the EU of around 8 trillion Euro, equal to almost 50% of EU GDP)
- The size of this increase is even more remarkable as mortgage lending is classified as low risk business correlated with some of the lowest loss rates across the EU. The above figures show a substantial misalignment between the risk profile of the underlying exposures and the design and calibration of the OF. The result is a significant loss of risk sensitivity, which results in mortgage markets carrying the strongest additional capital burden triggered by the implementation of the OF.
- An underlying justification for the introduction of the OF is concerns regarding the reliability of IRB models. However, these models and the associated data requirements are put through rigorous approval procedures. Since 2017 when the Basel agreement was concluded, any concerns have been addressed by the European Central Bank (ECB) and the European Banking Authority (EBA).
- Specifically, the ECB conducted a targeted review of internal models from 2016 to 2020 (TRIM). And the EBA designed a corresponding IRB Roadmap with new guidelines that have been implemented by bank supervisors. Moreover, IRB models are under constant monitoring by the supervisory authorities.
- Although often invoked, there is no robust evidence that IRB models are procyclical. The EBA has stated that *"Stylised facts on the EU banking sector and the real economy do not provide strong evidence of the regulatory capital requirements having had pro-cyclical effects. While capital levels of the EU banking sector have significantly increased since risk-sensitive capital requirements were first introduced in the EU (i.e. 2008), this seems not to have been driven by higher minimum capital requirements (MRC) due to any cyclicity of underlying Internal Ratings-Based (IRB) risk parameters (i.e. mainly PD and LGD), which have remained relatively stable over this period."*²

➤ **IRB banks expect average capital increases of 24%**

- Focusing the impact assessment on IRB banks, the additional capital needs are even higher: they will be confronted with an average capital increase of 24% for their mortgage loan books.
- Distributing this figure between the different customer types, it can be concluded that:
 - Household mortgages carry capital increases of 17% (11% including STA banks).
 - SME mortgages carry capital increases of 26% (23% including STA banks). This represents a substantial additional capital burden at the detriment of the backbone of the European economy
 - Corporate or commercial mortgage loans carry capital increases of 44% (40% including STA banks). Such an increase might turn out as a serious challenge for the funding of the real economy of the EU.

➤ **Residential mortgages for households: a permanent regime in favour of low-risk portfolios is of paramount importance to mitigate major negative consequences for consumers**

- The transposition of the OF in the CRR must be calibrated as neutrally as possible for residential mortgages. The target should be to avoid any substantial interest rate increases for private homeowners. Affordability of homeownership is at stake.
- The achievement of this target requires the proposed rules for low-risk residential mortgages to be maintained and turned into a permanent regime, and this across all Member States and not at Member State discretion.

² <https://www.eba.europa.eu/eba-recommends-retaining-risk-sensitive-framework-for-banks-regulatory-capital>

- Permanence is all the more justified as mortgage lending is generally designed as a long-term business which remains on the balance sheet of lenders until full redemption of the loans. In contrast to the 'originate to distribute model', the balance sheet tradition acts as a very efficient consumer protection tool where lenders accompany households over decades, addressing problems where relevant and being available to find appropriate solutions.
- A long-term relationship with households, alongside the dual recourse nature of mortgages, comes with a risk mitigation effect. There is no more robust and objective a tool for the measurement of the 'real' risk profile of exposures than loss rates (hard test requirement in Art. 465). In case of compliance, the proposed treatment under Art. 465 par.5 CRR would be justified without time limitation.
- Furthermore, and as indicated above, a permanent favourable regime for household mortgages is a cornerstone to address the climate change challenges, i.e. the investment needs triggered by the decarbonisation of the building stock and buildings' renovation.

➤ **Corporate mortgages: an average capital increase of 44% for IRB banks requires a similar treatment for commercial mortgages based on hard test requirements**

- The commercial mortgage business of IRB banks will be charged with a capital increase of 44%. Additional capital charges of 26% for mortgage loans to SMEs are also substantial although benefitting from the SME supporting factor.
- Both figures represent a material burden for the funding of the real economy. Many economic sectors and their growth capacities will be affected.
- Corporate mortgage lending will be fundamental to the transition towards a climate-neutral economy and the implementation of national housing policies. It is a major catalyst for the development of an ecosystem comprising a broad spectrum of stakeholders which can support financial stability and the attainment of the 2050 emission targets, in line with the EU Green Deal and the Renovation Wave Strategy.
- More specifically, commercial mortgages, together with households, are paramount for the funding of the renovation of the EU's building stock, 35% of which is over 50 years old and almost 75% of which is energy inefficient. Disproportionate capital increases will hamper the release of funds needed to fight against climate change.
- Again, there is no more robust and objective a tool for the measurement of the 'real' risk profile of exposures than loss rates (hard test requirements). Hence, we do not recognise compelling supervisory reasons for not applying the hard test requirement to corporate mortgages as well. In case of compliance with the hard test requirements (0.25%), risk weights for corporate/commercial mortgages would be subject to a similar rationale, i.e. be calibrated in consistency with those for residential mortgages.

Industry Priorities

With a view to securing the ability of the EU Mortgage Industry to: (1) support the climate transition and help secure the EU's energy independence, against a background of grave geo-political challenges and energy crisis, and (2) continue to represent a 'social lift' for households and a driver of the real economy, the EMF-ECBC would like to highlight the following priorities:

- The implementation of the Output Floor in the way proposed by the European Commission has a significant impact on real estate financing. To counter this impact and to avoid cliff effects, the preferential conditions in Art. 465(5) should be made permanent for residential mortgages that meet the 'hard test' (Art. 465(5)(a-b)) and 'dual claim' (Art. 465(5)(c)) requirements.

- Additionally, there is evidence that default rates of commercial mortgages evolve in a similar low range to residential mortgages, and it would therefore be justified to similarly apply a 'hard test' approach as in Art. 465(5) to these exposures also.
- The efforts to mitigate impacts through the 'hard test' arrangement in Art. 465 (which checks against average loss rates and the 'dual claim' mechanism) will however only deliver the beneficial treatment of 'low risk' mortgage portfolios for IRB banks, an approach that is not consistent with the fact that the 'hard test' is a risk mitigant for all secured mortgage loans, including those subject to the Standardised Approach. A 'hard test' brings conservatism into the framework, and it would be inconsistent for it to be only applied to IRB risk-weighted mortgages. Therefore, a more granular framework should also be applied to the Standardised Approach where both conditions are met: 10%RW for $\leq 55\%$ LTV and 45%RW for $>55\%$ LTV.
- With a view to ensuring the integrity of the EU financial market and a level-playing field, the national discretion in Art. 465(5) should be deleted so that the same rules apply across the EU.
- The proposed treatment of non-income producing real estate (non-IPRE) exposures in Art. 124(2) should be clarified to include, alongside the obligor's primary residence, secondary residences which are not rented out and therefore do not meet the definition of IPRE. This is important to preserve the EU's construction and real estate markets and support investment in real estate, which represents a safe and robust asset for the EU's citizens as savers, particularly in periods of high inflation.
- Regarding Acquisition, Development & Construction (ADC) exposures, the possibility of applying a 100% RW for residential real estate should be extended to ADC commercial real estate. Indeed, these typically finance transactions to construction firms or cooperatives that have already signed contracts with purchasers of the future finished property. The risk of the transaction is minimised by the fact that a substantial part of the property has already been sold.
- We welcome the revisions to Art. 208 around energy efficiency and value. This is important recognition of the Energy Efficient Mortgages Initiative (EEMI) and Label. The Basel implementation is a timely opportunity to consider the CRR's role in accelerating the 'greening' of banks' balance sheets and to increase sustainable investment under the CMU. Research under the EEMI³ and other Initiatives⁴ is pointing to the credit risk mitigation impact of energy efficiency and is making a strong risk-based case in a number of markets to consider a realignment of capital requirements for EEM.

³ <https://energyefficientmortgages.eu/wp-content/uploads/2021/07/Italian-Correlation-Analysis.pdf> & <https://energyefficientmortgages.eu/wp-content/uploads/2021/07/Extended-Dutch-Correlation-Analysis.pdf>

⁴ <https://op.europa.eu/en/publication-detail/-/publication/32387875-b94b-11ec-b6f4-01aa75ed71a1/language-en/format-PDF/source-255678423>