

Final European Mortgage Federation-European Covered Bond Council (EMF-ECBC) Comments on draft ECON Report & Proposals for Amendment to the European Commission's Proposal for a Revised Capital Requirements Regulation (CRR)

27 June 2022

Introduction

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. 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.

Comments on MEP Fernandez's Draft Report for ECON:

The EMF-ECBC recognises MEP Fernandez's amendments to the European Commission's proposal as a reflection of a broader intention to implement Basel 'faithfully'. While we acknowledge the importance of respecting the Basel Reforms, this cannot and must not come at the expense of the viability of the EU banking industry and the EU mortgage industry more specifically. Indeed, as indicated above, the EU mortgage industry is a major driver of the EU economy and will be fundamental to the recovery from the COVID-19 pandemic and to the financing of the climate transition.

With these considerations in mind, we would like to highlight the following concerns with regard to certain amendments put forward by MEP Fernandez:

- **Amendment 81 regarding Article 104(CRD), amendment 85 regarding Article 131 (CRD) and Amendments 87-89 regarding Article 133 (CRD):** The introduction of the output floor in the calculation of the total risk exposure amount (TREA) as set out in Article 92 of the CRR will have an impact on the own funds requirements set out in the CRD, the calculation of which depends on TREA. Of these requirements, the Pillar 2 Requirement (P2R) and the Systemic Risk Buffer Requirement (SyRB) can be used to address risks that are similar in nature to those addressed by the Output Floor. Consequently, there is a possibility that certain risks (e.g. model risk) could be double-counted once the Output Floor enters into application. In its proposal for a revised CRD, the European Commission insists on the need for this to be avoided in line with the EBA's advice on the Basel III finalisation, which includes a specific recommendation on this issue. It is therefore imperative that the safeguards introduced by the European Commission in Article 104 and 133 aimed at preventing unjustified increases in the P2R and the SyRB requirement when an institution is bound by the Output Floor be maintained. Equally, the amendment intended to clarify that the P2R and the SyRB requirement cannot be used to cover risks that are already fully covered by the OF should also be maintained. Finally, the requirement introduced by the European Commission that competent or designated authorities review the calibration of the O-SII buffer requirement of an O-SII when that O-SII becomes bound by the OF should also be maintained, in order to make sure that the calibration remains appropriate.
- **Amendments 75-80 and 87 & 89 regarding Article 124(2)(a) and Article 125 (1) and (2):** We recognise MEP Fernandez's efforts to address concerns that the European Commission's proposal in this area results in some exposures, e.g. secondary residences, being treated as IPRE exposures only because they do not meet any of the conditions from article 124(2)(a), even if they do not meet the definition of IPRE. However, we are concerned that the amendments proposed by MEP Fernandez result in a variety of unintended consequences, for example, that 'normal' residential real estate financing is not in scope of this Article because the income-producing criteria is not met. Furthermore, financing to owner-occupier cooperatives, which collectively finance a building with many apartments to live in them, would also not be in scope of this Article (point iii) because the income-producing criteria is not met. Below we propose a simpler amendment which would address the concern related to secondary residences without the unintended consequences described here.
- **Amendments 81 and 82 regarding Article 124(3) and 124(3)(a)(iii) (CRR):** The proposed amendments to Article 124(3) would result in the loan splitting approach being restricted to loans for property under construction or land to individuals only. Indeed, the proposed amendments to Art. 124(3) make a reference to Article 125(1) and 126(1) instead of to 124(2), while the proposed amendments to Article 124(3)(a)(iii) introduce a new requirement of lending to an individual. Given that Article 124(2) still requires compliance with all criteria of Article 124(3), loans for this purpose to companies, SMEs or corporates would not be eligible for the loan splitting approach. The reasoning for this amendment is not clear. The lending to an individual requirement would also not be in line with the reference to 126(1) in the heading of 124(3), because Art. 126 deals with commercial real estate where individuals are absent.
- **Amendment 198 regarding Article 208(3)(b) (CRR):** The proposed amendment requiring the value of the property to be kept constant as measured at loan origination in the calculation of the LTV would oblige lenders to ignore variations in property values over the longer term. Given that LTVs are the key determinant of risk weights, they should, at the very least, be accurate. We therefore strongly recommend maintaining the current Article 208(3) CRR, which provides lenders with the option to update the value of the property, also upwards, when justified by market developments. Allowing for this possibility is all the more justified when considering the fundamental differences between 'originate to distribute' and 'originate to hold' practices, such as those in the EU where mortgages are held on banks' balance sheets. Finally, the value at loan origination principle would also disadvantage Standardised Approach (SA) lenders compared to IRB

lenders in the EU, as an IRB lender is able to take account of the current value of the property for the purpose of determining the LGD.

- **Amendments 199-202 regarding Article 208(3a) (CRR):** Statistical valuation models are increasingly widely used and relevant in the context of the valuation of residential property and therefore have an important place in a digitalised mortgage business and a cross-border mortgage market. Furthermore, in its Guidelines on Loan Origination & Monitoring, the EBA recognises the role of statistical valuation models and allows for their use at origination, subject to valuer responsibility for the final valuation, as proposed by the European Commission. Limiting the use of statistical valuation models to monitoring and revaluation against this background represents a significant and unjustified step backwards from both a market and regulatory point of view, at a time when the use of these models has been steadily growing, delivering increasingly robust and reliable data. We strongly recommend maintain the European Commission's proposal in this area.
- **Amendments 292-297 regarding Article 465(5) (CRR):** 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 EU mortgage market are bound by the output floor. With this impact in mind, the European Commission proposed a specific transitional arrangement for low-risk exposures secured by mortgages on residential property when calculating the output floor in order to mitigate the disproportionate effects on these types of exposures. MEP Fernandez's proposal to further limit qualifying exposures to those secured by mortgages on residential property with an EPC A+ or A, which represent on average less than 1% of the EU's building stock, essentially renders the transitional arrangements ineffectual. On the contrary, and as outlined below, it is imperative that 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. Furthermore, 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. Finally and with a view to ensuring the integrity of the EU financial market and a level-playing field, there should no Member State or competent authority discretion in Art. 465(5) to ensure that the same rules apply across the EU.

EMF-ECBC Proposed Amendments to European Commission's Proposal for a Regulation:

Text proposed by the European Commission	Amendment
Article 124 – point a – point i (i) the immovable property securing the exposure is the obligor's primary residence, either where the immovable property as a whole constitutes a single housing unit or where the immovable property securing the exposure is a housing unit that is a separated part within an immovable property;	Article 124 – point a – point i (i) the immovable property securing the exposure is the obligor's primary residence or non-income producing secondary residence, either where the immovable property as a whole constitutes a single housing unit or where the immovable property securing the exposure is a housing unit that is a separated part within an immovable property;
Justification	

Under the new article 124 CRR, non-ADC exposures secured by residential immovable property which do not meet any of the conditions from article 124(2)(a) shall be treated under article 125(2) (*whole loan approach*), which is the treatment applicable to IPRE exposures. On the contrary, non-ADC exposures secured by residential immovable property, which meet any of the conditions from article 124(2)(a) shall not qualify as IPRE exposures and shall be treated under article 125(1) (*loan splitting approach*).

As a consequence, the application of the *whole loan approach* or *loan splitting approach* for non-ADC exposures secured by residential immovable property is subject to the fulfilment of any of the conditions from article 124(2)(a). However, conditions from article 124(2)(a) are mandatory and exclusive conditions; they have the effect to treat some exposures as IPRE exposures only because they do not meet any of the conditions from article 124(2)(a), even if they do not meet the definition of IPRE (article 4(1)(75b)). For instance, an exposure secured by a secondary residence which is not rented out shall fall under the treatment applicable to IPRE exposures although it does not meet the definition of IPRE.

On the contrary, under the Basel standards, the *whole loan approach* only applies when the prospects for servicing the loan materially depend on the cash flows generated by the property securing the loan rather than on the underlying capacity of the borrower to service the debt from other sources. The types of exposures excluded from this treatment, as listed under the Basel standards, are non-exhaustive.

To be aligned with Basel standards, a non-IPRE exposure (as defined in article 4(1)(75b)) which fails to meet any of the conditions from article 124(2)(a) should be treated under the *loan splitting approach* (article 125(1)).

Text proposed by the European Commission	Amendment
Article 126a – paragraph 2 – introductory part 1. ADC exposures to residential property, however, may be risk weighted at 100 %, provided that, where applicable, the institution applies sound origination and monitoring standards which meet the requirements of Articles 74 and 79 of Directive 2013/36/EU and where at least one of the following conditions is met:	Article 126a – paragraph 2 – introductory part 2. ADC exposures to residential and commercial property, however, may be risk weighted at 100 %, provided that, where applicable, the institution applies sound origination and monitoring standards which meet the requirements of Articles 74 and 79 of Directive 2013/36/EU and where at least one of the following conditions is met:
<i>Justification</i> The possibility of applying a 100% RW for ADC exposures to 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.	

Text proposed by the European Commission	Amendment
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Article 129 – Paragraph 4

4. Covered bonds for which a credit assessment by a nominated ECAI is available shall be assigned a risk weight according to Table 6a which corresponds to the credit assessment of the ECAI in accordance with Article 136.

Table 6a

Credit quality step	1	2	3	4	5	6
Risk weight	10 %	20 %	20 %	50 %	50 %	100 %

Article 129 – Paragraph 4

4. Covered bonds for which a credit assessment by a nominated ECAI is available shall be assigned a risk weight according to Table 6a which corresponds to the credit assessment of the ECAI in accordance with Article 136.

Table 6a						
Credit quality step	1	2	3	4	5	6
Risk weight	10%	15%	20%	50%	50%	100%

Exposures in the form of derivatives for hedging purposes as referred to in Articles 11 and 4 of Directive (EU) 2019/2162 shall be assigned the same risk weight that the derivative counterparty would assign to the covered bonds.

Article 129 – Paragraph 5

5. Covered bonds for which a credit assessment by a nominated ECAI is not available shall be assigned a risk weight on the basis of the risk weight assigned to senior unsecured exposures to the institution which issues them. The following correspondence between risk weights shall apply:

- a) if the exposures to the institution are assigned a risk weight of 20 %, the covered bond shall be assigned a risk weight of 10%;
- b) if the exposures to the institution are assigned a risk weight of 50 %, the covered bond shall be assigned a risk weight of 20%;
- c) if the exposures to the institution are assigned a risk weight of 100 %, the covered bond shall be assigned a risk weight of 50%;
- d) if the exposures to the institution are assigned a risk weight of 150%, the covered bond shall be assigned a risk weight of 100%.

Article 129 – Paragraph 5

5. Covered bonds for which a credit assessment by a nominated ECAI is not available shall be assigned a risk weight on the basis of the risk weight assigned to senior unsecured exposures to the institution which issues them. The following correspondence between risk weights shall apply:

- a) if the exposures to the institution are assigned a risk weight of 20 %, the covered bond shall be assigned a risk weight of 10%;
- b) if the exposures to the institution are assigned a risk weight of 50 %, the covered bond shall be assigned a risk weight of 20%;
- c) if the exposures to the institution are assigned a risk weight of 100 %, the covered bond shall be assigned a risk weight of 50%;
- d) if the exposures to the institution are assigned a risk weight of 150%, the covered bond shall be assigned a risk weight of 100%.

	<i>Exposures in the form of derivatives for hedging purposes as referred to in Articles 11 and 4 of Directive (EU) 2019/2162 shall be assigned the same risk weight that the derivative counterparty would assign to the covered bonds.</i>
Article 161 – Paragraph 1 – Point d Loss Given Default (LGD) 1. Institutions shall use the following LGD values: d) covered bonds eligible for the treatment set out in Article 129(4) or (5) may be assigned an LGD value of 11,25%;	Article 161 – Paragraph 1 – Point d Loss Given Default (LGD) 1. Institutions shall use the following LGD values: d) covered bonds and derivatives eligible for the treatment set out in Article 129(4) or (5) may be assigned an LGD value of 11,25%;
<i>Justification</i> Articles 129 (4) and (5) should be amended to not only include covered bonds but also “covered derivatives” as eligible for the preferential treatment in paragraph 4 and 5, and, hence, a LGD of 11.25 per cent according to Article 161(1)(d). This is justified with reference to the new Covered Bond Directive (2019/2162/EU) detailing the requirements for derivatives to qualify as “covered derivatives”. This amendment would rightly and better reflect the equal rights in the cover pool (i.e. ranking pari passu). Any preferential treatment would be limited only to derivative counterparties of a covered bond issuer. It would also encourage prudent risk management in the cover pool. We also take this opportunity to propose that the risk weight in credit quality step 2 should be reduced to 15% due to the amended risk weight for credit institutions with credit assessment by a nominated ECAI in Article 120.	

Text proposed by the European Commission	Amendment
Article 229 – Title & Paragraph 1 <i>Valuation principles for eligible collateral other than financial collateral</i> 1. <i>The valuation of immovable property shall meet all of the following requirements:</i> a) <i>The value shall be appraised independently from an institution’s mortgage acquisition, loan processing and loan decision process by an independent valuer who possesses the</i>	Article 229 – Title & Paragraph 1 <i>Valuation principles for other eligible collateral under the IRB Approach</i> 1. <i>For immovable property collateral, the collateral shall be valued by an independent valuer at or at less than the market value. An institution shall require the independent valuer to document the market value in a transparent and clear manner.</i>

<i>necessary qualifications, ability and experience to execute a valuation;</i> <i>b) the value is appraised using prudently conservative valuation criteria which meet all of the following requirements:</i> <i>(i) the value excludes expectations on price increases;</i> <i>(ii) the value is adjusted to take into account the potential for the current market price to be significantly above the value that would be sustainable over the life of the loan;</i> <i>c) the value is not higher than a market value for the immovable property where such market value can be determined.</i> The value of the collateral shall reflect the results of the monitoring required under Article 208(3) and take account of any prior claims on the immovable property.	<i>In those Member States that have laid down rigorous criteria for the assessment of the mortgage lending value in statutory or regulatory provisions, <u>institutions may decide that the immovable property may instead be valued by an independent valuer at or at less than the mortgage lending value. Institutions shall require the independent valuer not to take into account speculative elements in the assessment of the mortgage lending value and to document that value in a transparent and clear manner.</u></i> <i>The value of the collateral shall be the market value or mortgage lending value <u>adjusted as appropriate to reflect the results of the monitoring required under Article 208(3) and to take account of any prior claims on the immovable property.</u></i>
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Justification

We strongly believe that there is a material risk of disrupting the valuation practices currently in use in Europe were the market value approach to be replaced by a new and untested basis of value. The appraisal and valuation framework applied across EU Member States has been developed over many years culminating in recognised valuation concepts, definitions and methods. The applications of Market Value and Mortgage Lending Value are established, standardised, tried and tested and well understood by both valuers and lenders.

The challenges related to the introduction of a new prudent value approach cover all aspects of property valuation methodology, ranging from the overall concept of value through definitions and data availability to applications at both macro and micro levels.

In light of these considerations, it is extremely important to maintain the current option in CRR to apply market value or mortgage lending value to value real estate in CRE or RRE in order to ensure that valuations are based on proven standards and implemented by qualified valuers based on a long-term data basis. To reflect the possibility currently enshrined in Art. 208(3) CRR of an upward revision of values when justified by market developments and therefore to ensure consistency, we recommend replacing 'reduced' by 'adjusted' in the third subparagraph of Art. 229(1), as amended above.

Text proposed by the European Commission	Amendment
Article 465 – Paragraph 5 – Subparagraph 1 - Introductory Part	Article 465 – Paragraph 5 – Subparagraph 1 - Introductory Part

<i>Transitional</i> arrangements for the output floor	Arrangements for the output floor
5. By way of derogation from Article 92(5)(a), point (i), Member States may, allow parent institutions, parent financial holding companies or parent mixed financial holding companies, stand-alone institutions in the EU or stand-alone subsidiary institutions in Member States to assign the following risk weights provided that all the conditions in the second subparagraph are met.	5. By way of derogation from Article 92(5)(a), point (i), parent institutions, parent financial holding companies or parent mixed financial holding companies, stand-alone institutions in the EU or stand-alone subsidiary institutions in Member States may assign the following risk weights provided that all the conditions in the second subparagraph are met.
<i>Justification</i> 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.	

Text proposed by the European Commission	Amendment
Article 465 – paragraph 5 – subparagraph 2 a) until 31 December 2032, a risk weight of 10 % to the part of the exposures secured by mortgages on residential property up to 55 % of the property value remaining after any senior or pari passu ranking liens not held by the institution have been deducted, b) until 31 December 2029, a risk weight of 45% to any remaining part of the exposures secured by mortgages on residential property up to 80 % of the property value remaining after any senior or pari passu ranking liens not held by the institution have been deducted, provided that the adjustment to own funds requirements for credit risk referred to in Article 501 is not applied.	Article 465 – paragraph 5 – subparagraph 2 a) A risk weight of 10 % to the part of the exposures secured by mortgages on residential property up to 55 % of the property value remaining after any senior or pari passu ranking liens not held by the institution have been deducted, b) A risk weight of 45% to any remaining part of the exposures secured by mortgages on residential property up to 80 % of the property value remaining after any senior or pari passu ranking liens not held by the institution have been deducted, provided that the adjustment to own funds requirements for credit risk referred to in Article 501 is not applied.
<i>Justification</i> 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.	

Text proposed by the European Commission	Amendment
	Article 465 – paragraph 5 – subparagraph 2a (new) <i>a) A risk weight of 30 % to the part of the exposures secured by mortgages on commercial property up to 55 % of the property value remaining after any senior or pari passu ranking liens not held by the institution have been deducted.</i>
Justification 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 for exposures secured by mortgages on residential property in the European Commission’s proposed Art. 465(5), to these exposures also.	

Text proposed by the European Commission	Amendment
Article 465 – paragraph 5 – subparagraph 3 Where the discretion referred to in the first subparagraph has been exercised and all the associated conditions in the second subparagraph are met, institutions may assign the following risk weights to the remaining part of the exposures referred to in the second subparagraph, point (b), until 31 December 2032: a) 52,5 % during the period from 1 January 2030 to 31 December 2030; b) 60 % during the period from 1 January 2031 to 31 December 2031; c) 67,5 % during the period from 1 January 2032 to 31 December 2032.	Article 465 – paragraph 5 – subparagraph 3 Deleted
Justification 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.	

Text proposed by the European Commission	Amendment
Article 465 – paragraph 5 – subparagraph 4 When Member States exercise that discretion, they shall notify EBA and substantiate their decision. Competent authorities shall notify the details of all the verifications referred to in the first subparagraph, point (c), to EBA.	Article 465 – paragraph 5 – subparagraph 4 <i>Deleted</i>
Justification 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.	

Text proposed by the European Commission	Amendment
Article 465 – paragraph 5 – subparagraph 5 EBA shall monitor the use of the transitional treatment in the first subparagraph and report to the Commission by 31 December 2028 on the appropriateness of the associated risk weights.	Article 465 – paragraph 5 – subparagraph 5 <i>Deleted</i>
Justification 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.	

Text proposed by the European Commission	Amendment
Article 465 – paragraph 5 – subparagraph 6 On the basis of that report and taking due account of the related internationally agreed standards developed by the BCBS, the Commission shall, where appropriate, submit to the European Parliament and to the Council a legislative proposal by 31 December 2031	Article 465 – paragraph 5 – subparagraph 6 <i>Deleted</i>
Justification 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.