

European Mortgage Federation-European Covered Bond Council (EMF-ECBC) Comments to Council of EU for Amendment to the European Commission's Proposal for a Revised Capital Requirements Regulation (CRR)

4 October 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. 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.

In light of the tangible risk of 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.

The EMF-ECBC would like to highlight the following issues:

Article 465(5) - loans secured by real estate in the output floor calculation: the proposed treatment must be maintained, made available for commercial mortgage lending as well and turned into a permanent regime

1. The implementation of the Output Floor (OF) in the way proposed by the European Commission has a significant impact on real estate financing:

- Research¹ provides evidence that around two-thirds of IRB exposures in the EU mortgage market (= 28% of the total EU credit assets) are bound by the output floor. Outstanding mortgage loans in the EU amount to around 8 trillion Euro equal to almost 50% of EU GDP.
- EU mortgage lenders will be faced with average capital increases of their mortgage portfolios of 18%, i.e. well beyond the G-20's initial target of 10%.

¹ <https://hypo.org/app/uploads/sites/3/2022/05/Impact-of-Final-Basel-III-Final-Report-Copenhagen-Economics-May-2022.pdf>

- As regards IRB banks, they will be face even higher capital increases of 24% which can be broken down into 17% for household mortgages, 26% for SME mortgages and 44% for corporate or commercial mortgages
- Such substantial capital increases constitute a serious threat for the funding of the real economy of the EU and the investment needs triggered by the decarbonisation of the EU building stock (220 million homes to be renovated by 2050).
- 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, pointing to a substantial misalignment between the risk profile of the underlying exposures and the design and calibration of the OF.
- Hence, the implementation of the OF results in mortgage markets carrying the strongest additional capital burden. EU mortgage lenders will be challenged by systemic and competitive consequences, e.g. the increase of off-balance funding schemes, shift of mortgage business from regulated to non- or less regulated lenders (growing shadow banking), weakening of long-termism and long term funding instruments such as covered bonds.

2. Treatment of low-risk residential mortgages: A permanent regime for low-risk residential mortgage portfolios is of paramount importance to mitigate major negative consequences for consumers:

- In transposing the OF, caution should be exercised to avoid any substantial interest rate increases for private homeowners, to secure the affordability of homeownership and to address the climate change challenges.
- This requires that the proposed rules for low-risk residential mortgages be maintained and transformed into a permanent regime, and this across all Member States and not at Member State discretion in order to ensure a level playing field across all EU mortgage markets.
- 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, we do not see convincing supervisory arguments to subject the proposed treatment under Art. 465 par.5 CRR to time limits.
- In addition, mortgage lending is generally designed as a long-term business which remains on lenders’ balance sheet until full redemption. 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. This translates – together with the double recourse mechanism – into a substantial risk mitigation effect.

3. Treatment of commercial mortgages: the almost incommensurate average capital increase of 44% for IRB commercial mortgage exposures requires a treatment similar to residential mortgage exposures based on hard test requirements

- Such a substantial capital increase represents 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
- 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.
- From a supervisory perspective, as there is no more robust and objective a tool for the measurement of the ‘real’ risk profile of exposures than loss rates, there are no 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 should be subject to a similar rationale, i.e. be calibrated in consistency with those for residential mortgages.

Article 124 – Immovable Property: closing the gap to the detriment of non-IPRE secondary residences

4. The European Commission's 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.
5. We therefore support Member States' efforts to recognise secondary residences as non-IPRE exposures.

Article 126 – Commercial real estate exposures

6. **More risk sensitivity and granularity of the STA approach for commercial property is required:**
 - To mitigate the additional capital burden for commercial real estate lending in comparison with the current regime, a more risk sensitive treatment of non-IPRE exposures secured by commercial property is required. Should the hard test enshrined in Article 126(2) be met, a risk weight of 50% for non IPRE commercial real estate up to an ETV of 55% shall apply.
 - In the same logic, it is important to complement the risk weight table 6c of Art. 126 with an additional risk weight bucket of 60% in case of ETV ratios below 50% in order to increase the risk sensitivity for commercial mortgages and increase the risk weight granularity of the table.
7. **Preferential treatment of ADC exposures should be extended to commercial real estate exposures:** 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 loans 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.

Articles 208 & 229 – Property Valuation

We are concerned that proposals to date to amend the European Commission's text in the area of property valuations are not compatible with the long-established and efficient day-to-day practice of valuers for the purpose of valuing property and could, furthermore, give rise to legal uncertainty and undermine financial stability.

8. **Prudently conservative valuation criteria are reflected in the MV and MLV**
 - We recognise the intention of the Basel Committee to ensure that valuation practice is underpinned by prudently conservative valuation criteria. However, for reasons of consistency and legal certainty, the valuation of property for lending purposes must be rooted in well-understood, standardised and tried and tested bases of value and regulation in this area must be consistent with the realities of valuation practice.
 - In this respect, a 'prudent value' approach is reflected in the mortgage lending value and in a market value approach complemented by conservative valuation criteria, which might translate into market value adjustments. Both bases of value therefore remain fit for purpose, addressing all the requirements of prudence as per the Basel III recommendations.

- Any other approach, which might see the introduction of a 'prudent value' as a new and untested basis of value, could give rise to a situation under the CRR in which valuers would be required to deliver up to three values for the same property depending on the purpose: a market value, a mortgage lending value and a prudent value.
 - A requirement of this kind would be contrary to long-established and efficient valuation practice, according to which valuers, logically, deliver one valuation report per loan, and could give rise to liability concerns.
- 9. Advanced Statistical Valuation Models should be permitted at origination subject to valuer control:**
- Advanced statistical valuation models are an established tool used by valuers, alongside a variety of other tools, as a valuable source of comparative data in the context of their valuation activities. They have an important place in a digitalised mortgage business and a cross-border mortgage market.
 - It is therefore of the utmost importance that the European Commission's proposal, which allows for their use, subject to valuer control and responsibility, for the origination and revaluation of real estate, be maintained. The European Commission's proposal is fully aligned with the EBA's Guidelines on Loan Origination & Monitoring in this respect.
 - Limiting the use of advanced statistical valuation models to monitoring only is not consistent with valuation best practice principles and would reverse valuable digital evolution, which is delivering increasingly high-quality models.
- 10. Upward revision of values should be permitted subject to European Commission 'average value' principle:**
- We believe the European Commission's proposal in Art. 208 - which is intrinsically linked to the monitoring requirements in the same article - to cap the upward adjustment of values beyond the value at loan origination in the context of revaluation to certain average values for residential and commercial property is a proportionate and appropriate way of mitigating the impact of procyclicality on property valuations and ensuring more stability in the capital requirements for mortgages.
 - We are therefore concerned about the Council's proposal to move the 'average value' principle to Art. 229 which contains the requirements for the so-called 'property value', the prudent valuation concept adopted from Basel III.
 - The practical consequence of this would be the introduction of two new valuation approaches to be used depending on the moment of the valuation (initial valuation (market value)/revaluation (average value)). This is not comprehensible from a valuation methodological point of view and would result in a completely non-transparent valuation approach for the property value.
 - We would also like to express concerns about the potential implementation of the average value for all valuation moments, including the initial valuation. This would go significantly beyond the requirements of Basel III.
 - As indicated above, the intention of the European Commission's draft was to introduce an average value as an additional security in the event of an increase in value above the value at origination - independent from the requirements for the property value and therefore, in our view, correctly located with the monitoring requirements in Art. 208 (3) CRR.
- 11. Transitional period – new valuation rules should apply to newly originated exposures only:**
- We are concerned by the European Commission's proposal that the new valuation rules will apply not only to newly originated exposures but also to the stock of existing exposures. This would require that the whole stock of exposures would have to be revalued by 31 December 2024, including those properties for which there is no reason for revaluation.
 - We recognise Member States' acknowledgement of this concern and the subsequent proposal to introduce a three year transition period to mitigate impacts, however, the Industry's concern remains as such a

transitional period does not sufficiently address the enormous burden for lending institutions, especially in the retail business of private housing finance.

- Indeed, this could result in lending institutions having to request updated documents from the customer, having to carry out inspections and document revaluations for the whole stock of existing real estate exposures. In many countries that would probably only be possible on a voluntary basis.
- We therefore propose that the new valuation rules apply only to newly originated exposures and in case of revaluation. This could be achieved with the following amendment:

‘Article 495e Transitional arrangements for property revaluation requirements

*By way of derogation from Article 229(1), for exposures secured by residential property or commercial immovable property granted before [OP please insert date = date of application of this amending Regulation], institutions may continue to value residential property or the commercial immovable property at or less than the market value, or in those Member States that have laid down rigorous criteria for the assessment of the mortgage lending value in statutory or regulatory provisions, the mortgage lending value of that property, until a review of the property value is required in accordance with Article 208(3), **and the review of the property value results in a revaluation being necessary.***
