

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

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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.

Against this background, we strongly support amendments 1298 to 1310 and 1312 to 1318 which propose to make permanent the preferential conditions in Art. 465(5) for residential mortgages that meet the ‘hard test’ (Art. 465(5)(a-b)) and ‘dual claim’ (Art. 465(5)(c)) requirements.

We furthermore strongly support amendment 1336, which provides for a 45% risk weight for the remaining part of the loan with LTV above 55% and up to 80%, as well as amendment 1338 in combination with amendments 1345 to 1346 and 1352 to 1354, which provide for a 60% risk weight for the remaining part of the loan beyond 55% and to 80 % of the property value.

We finally support amendments 1291 to 1296 which propose to replace the reference to “Member States” with a reference to “credit institutions”.

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.

We therefore strongly support amendment 1319, which introduces a specific proposal for a lower risk for commercial real estate in the output floor, and amendment 1387 which proposes an EBA mandate for the assessment of risk weight adjustments for commercial mortgages.

Article 124 – Immovable Property: closing the gap at 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.

With these considerations in mind, we strongly support either amendments 790-793 or amendment 794, which secure the appropriate treatment of secondary residences as non-IPRE exposures.

Article 126 – Commercial Property: more risk sensitivity and granularity of the STA approach

5. 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 shall apply.

In the same logic, it is important to complement the risk weight table 6c of Article 126 with an additional risk weight bucket of 50% in case of ETV ratios below 60% in order to increase the risk sensitivity for commercial mortgages and increase the risk weight granularity of the table.

We therefore strongly support amendments 822 and 823.

Article 126a – ADC Exposures: inclusion of commercial real estate exposures

6. 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.

We therefore support amendments 824-835 which provide for the extension of the 100% risk weight for residential ADC to commercial ADC.

Articles 208 & 229 – Property Valuation

We are concerned that the vast majority of amendments tabled by the ECON Committee to the European Commission's proposals in this area 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.

7. Prudent value

- 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.

We therefore strongly support amendment 1025 which reintroduces the option to apply market value or mortgage lending value. We support also amendment 1026 which modifies the requirement for being sustainable.

8. Advanced Statistical Valuation Models

- 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.

We strongly recommend maintaining the European Commission's proposal in this area and, in this respect, strongly support amendments 1009 and 1010 which secure the possibility for the use of statistical valuation methods at origination.

9. Upward revision of values

- In recognition of the fundamental importance of the accuracy of loan to value (LTV) ratios given their role as a key determinant of mortgage risk weights, the existing Article 208(3) CRR does not exclude the option to update property values also upwards when justified by market developments. This option is rooted in the close and regular monitoring and revaluation requirements – a practice which is not embedded in the Basel framework and is therefore specific to the EU. Nonetheless, the possibility to revise the 'V' in the LTV upwards is expressly allowed for in the Basel III Recommendations (point 62) as well under strict conditions which are also reflected by the Commission's Proposal.
- The existing monitoring requirement in the CRR is maintained in the European Commission's Proposal but upwards adjustment beyond the value at loan origination in the context of revaluation is capped at the average value over the last three years for commercial property and over the last six years for residential property.
- This represents a proportionate and appropriate way of mitigating the impact of procyclicality on property valuations and ensuring more stability in the capital requirements for mortgages.
- It is therefore unjustified to remove this possibility for lending institutions and instead introduce the value at loan origination principle.

We therefore strongly support amendments 999 and 1000 which clarify the rationale for the European Commission's proposal and maintain the possibility of the upward of revision of values.