Basel III & CRR III: main conclusions from a mortgage lenders’ and covered bond issuers’ perspective

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The Timetable

- Basel III reform package
  - December 2017: presentation of the Basel III reform package
  - January 2023: entry into force of the Basel III package after 1 year deferral in response to the Covid crisis
- EU Capital Requirements Regulation (CRR III)
  - October 2021: COM legislative proposal transposing the Basel III package into European law
  - 19 June 2024: publication of the CRR III in the OJ of the European Union (Regulation 2024/1623 of 31 May 2024)
  - 1 January 2025: entry into force of the CRR III with the exception of the Fundamental Review of the Trading Book (FRTB)

Main purpose of the BCBS and EU initiatives: response to the GFC

- Revision of the Standardised Approach to make risk-based capital ratios more granular and risk sensitive
- Cutback of the IRB Approach regarding the scope for banks to design and use rating models (introduction of input floors and removal of the IRBA for certain types of exposures)
- Introduction of an output floor of 72,5% limiting the extent to which banks’ risk-weighted assets generated by internal models can be lower than calculated by the standardised approaches

Art. 125 CRR: Risk weights of Residential Real Estate

Main criteria: Exposure to Value ratio (ETV) and Income Producing (IPRE)

- Owner occupied (non-IPRE, loan splitting approach)

ETV	ETV < 55%	ETV > 55%
Risk weight	20%	75% (retail unsecured)

-> Basel III provides the same table but also offers a non-IPRE whole loan approach with lower risk weights for ETVs > 55% (RRE exposures not materially dependent on cash flows generated by the property, CRE 20.82)

- Income producing (IPRE, whole loan approach)

ETV	ETV ≤ 50 %	50 % < ETV < 60 %	60 % < ETV < 80 %	80 % < ETV < 90 %	90 % < ETV <100 %	ETV > 100 %
Risk weight	30 %	35 %	45 %	60 %	75 %	105 %

-> Basel III provides the same table (RRE exposures materially dependent on cash flows generated by the property, CRE 20.84)

Art. 126 CRR: Risk weights of Commercial Real Estate

Main criteria: Exposure to Value ratio (ETV) and Income Producing (IPRE)

- Owner occupied (non-IPRE, loan splitting approach)

ETV	ETV < 55%	ETV > 55%
Risk weight	60%	100% (corporate unsecured)

-> Basel III provides the same table, commercial real estate not materially dependent on cash flows generated by the property, CRE 20.86)

- Income producing (IPRE, whole loan approach)

	ETV ≤ 60 %	60 % < ETV ≤ 80 %	ETV > 80 %
Risk weight	70 %	90 %	110 %

-> Basel III provides the same table, commercial real estate materially dependent on cash flows generated by the property, CRE 20.87)

A New Valuation Approach: The Property Value (Art. 229 CRR)

The property value is appraised using prudently conservative valuation criteria which meet all of the following requirements:

(i) the value excludes expectations on price increases;
(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;

EBA advice of August 2019:

- Art. 229 CRR will no longer allow institutions to solely apply a Market Value concept
- institutions currently using the Market Value concept would be allowed to continue to do so, provided that **the values used as input parameters are 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.
- Challenge: how to determine or measure the adjustment ratio?

Conclusions Real Estate Risk Weights

- Residential Real Estate
  - the new CRR regime appears more favorable compared to the current regime, especially as regards mortgages with low ETV ratios and non-IPRE lending.
- Commercial Real Estate
  - The new regime will be less favourable than the current one, the lowest risk weights of 60% (non-IPRE) and 70% (IPRE) are clearly higher than the current ratios.
- For both RRE & CRE, the more favorable non-IPRE risk weights also apply to IPRE assets where loss rates pass so-called 'hard tests', i.e. losses of maximum 0.3% up to 55% of the property value and of maximum 0.5% up to 100% of the property value.
- ETV ratios are measured against a (prudential) Property Value instead of Market Value of the property. This reduces the proportion of preferential risk weights for mortgage lenders.

Risk weights of externally rated Covered Bonds

- Article 129 par. 4 CRR

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

- Basel Framework CRE 20.38:

Risk weight table for rated covered bond exposures					Table 8
Issue-specific rating of the covered bond	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-
"Base" risk weight	10%	20%	20%	50%	100%

Risk weights of non-rated Covered Bonds

- Article 129 par. 5 CRR: Risk weights of non-rated covered bonds are based on senior unsecured risk weights of the issuing institution

Senior unsecured risk weight	20%	30%	40%	50%	75%	100%	150%
Covered Bond risk weight	10%	15%	20%	25%	35%	50%	100%

- Article 129 par. 5 CRR is a copy of the Basel III risk weight table for unrated covered bond exposures CRE 20.38

Article 129 par. 3 CRR: Valuation of Cover Assets

- Competent authorities may allow that real estate cover assets continue to be valued at or at less than the Market Value or at the Mortgage Lending Value by way of a derogation from Article 229 CRR. But this derogation only applies to property valuation for cover pool eligibility and not to risk weighting purposes in accordance with Articles 124 to 126 CRR.

Introduction of an Output Floor of 72,5% (Art 92 par. 3 CRR)

The output floor applies to banks using internal rating models (IRBA-Banks) and puts a limit on the amount of capital benefit a bank can obtain from the use of internal models relative to the Standardised Approach.

- All IRBA banks are required to apply the Standardised Approach as well.

Banks' calculations of risk-weighted assets generated by internal models cannot, in aggregate, fall below 72.5% of the RWAs computed by the Standardised Approach. This limits the benefit a bank can gain from using internal models to 27.5%.

A significant number of mortgage lenders using the IRBA are bound by the OF because IRBA risk weights of their mortgage business are lower than 72,5% of the Standardised Approach risk weights

The lower the risk profile of mortgage portfolios, the more restrictive the OF. The 72.5% calibration is progressively phased in until 2030 starting with an OF of 50%.

A transitional regime for RRE applies until 2032 (Art. 465 par. 5 CRR)

EU deviation from Basel III: The transitional regime for RRE to mitigate the OF constraints (Art. 465 par. 5 CRR)

The regime is conceived as a national discretion (Member States may allow institutions..)

Until 31 December 2032, application of a risk weight of 10% (instead of 20%) up to 55% ETV of the non-IPRE RRE (splitting approach, owner-occupied)

Until 31 December 2029, a preferential 45% risk weight applies to ETV ratios between 55% and 80%, then increasing every year and phased out on 31 December 2032

Over the last eight years the institution's losses in any given year on the part of the exposures secured by mortgages on RRE up to 55 % of the property value do not exceed on average 0,25 % of the sum of the exposure values of all outstanding RRE mortgages

The lender shall have a right on other assets and income of the obligor either contractually or by applicable national law

EBA is required to submit a report to the Commission on 31 December 2028, any potential prolongation of this regime being limited to four years

Copenhagen Economics: Impact of final Basel III on the EU mortgage sector

(https://copenhageneconomics.com/publication/finalbaseliii-and-the-eumortgagesector/)

Residential mortgage portfolios under the Standardised Approach benefit from lower risk weights -> decline in capital requirements of around 11% -> material capital relief for smaller and mid-sized banks using the Standardised Approach -> also valid for most banks in new EU Member States

IRB banks/IRB bank countries with significant mortgage exposures will suffer the most -> capital increases from 7% to 37% for RRE mortgage portfolios -> FR, DE & the Nordics, while other IRB bank countries such as IT are less or not bound by the OF (IRB effect below 27,5%)

Final OF impact differs depending on the composition of mortgage portfolios

- the proposed transitional regime (Art. 465 par. 5 CRR) widely neutralises OF driven capital increases for owner occupied RRE
- capital increases for corporate or commercial mortgage lending (CRE) are dampened by SME supporting factor (+9 bp for SME mortgages, +16bp for corporate borrowers)

EU lead vs. BCBS on ESG

➢ Latest BCBS initiatives

- Publication of Principles for the effective management and supervision of climate-related financial risks, June 2022
- Consultation of November 2023 on disclosure of climate-related financial risks (deadline 14 March 2024)

➢ EU climate policy targets reflected within the CRR

- ESG definition and enumeration of ESG factors (Art. 52d to 52i CRR)
- Supervisory reporting and disclosure requirements: information on exposures to ESG risks in order to ensure comprehensive transparency towards the markets (Art. 430 and 449a CRR -> COM ITS on Pillar III ESG disclosure of 30 November 2022)
- Appropriate reflection of ESG risks in ECAI credit risk rating methodologies (Art. 135 CRR)
- Inclusion in the property valuation/review of values of ESG –related considerations (Art. 208(3) CRR)
- CfA to EBA July 2023 to assess enhancing the disclosures of ESG risk of cover pools
- Assessment of the correlation between ESG risk drivers and financial risks -> EBA mandate to report on whether a dedicated prudential treatment of exposures related to assets or activities substantially associated with environmental or social objectives would be justified (Art. 501c CRR).

Key objectives of the EBA's roadmap on sustainable finance

Pillar I: EBA advice on prudential treatment expected July 2024 & December 2026 (Art. 501c CRR)

The Global Dimension: The US Basel III endgame proposal of July 2023

- In the US, it is proposed that Basel III will only apply to approx. 36 large firms, i.e. banks holding assets beyond 100 bn $ - while it will cover approx. 5.000 institutions in the EU
- The main systemic change in the US consists of a ‘de facto’ removal of the IRB approach: it is replaced by a revised more risk based standardised approach called ‘expanded risk based approach’.
- IRBA only remains available for market risk measurement
- As a consequence, the output floor is not of concern for the US banking industry. Capital relief of more than 27,5% produced by internal rating models for market risk measurement is very unlikely.
- Large US firms will be applying a dual approach composed by the traditional standardised approach and the new expanded risk based approach: the higher capital requirements of the two will apply.
- Less significant US institutions continue to be submitted to the standardised approach

US Basel III implementation as regards real estate lending and property valuation

- The treatment of real estate is fully compliant with Basel III (RRE and CRE classified cash flow and not cash flow dependent)
- A hard test option with lower risk weights (20% and 60%) is not available.
- The Market Value applies. Property valuations must follow the so called 'appraisal rule', i.e. a package of statutory provisions which are Market Vale based.
- The 'Prudent Value' would only apply to exposures not subject the appraisal rule. Most real estate exposures held by insured depository institutions are subject to the supervisory appraisal rule.
- The application of a Prudent Property Value in the US might turn out as a niche business, potentially restricted to cross border mortgage lending of US banks

Application of Basel III in the US: 1 July 2025 with a 3-years phase-in period