1.2 COMPETITIVENESS IN THE COVERED BOND MARKET IN A CHANGING REGULATORY LANDSCAPE

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EUROPEAN BANKING REGULATION IS INCREASINGLY PROVING TO BE A STUMBLING BLOCK

The international competitiveness and capability of European banks is under growing pressure. This is driven not only by the economic environment, but also by the digital and environmental transformation and intensifying competition from capital market players.

Yet the key problem lies deeper: Europe is not consistently implementing the final Basel III rules in line with actual needs, whilst in other parts of the world they are being introduced with delays, only partially, or with greater regulatory flexibility. The result is a competitive gap that is particularly noticeable in capital-intensive and economically significant financing. This is especially true of property financing. Although the Bank for International Settlements notes in its BIS/BCBS monitoring of implementation in member jurisdictions as at the end of September 2025 that the majority of the final Basel III elements are now in force in many countries, its monitoring also shows that implementation is not fully synchronised internationally and is not equally advanced everywhere. Furthermore, the US and the UK, among others, have announced that they do not intend to implement the requirements in full.

With the reform of the 2024 banking package, Europe has adopted CRR3, thereby transposing the final Basel III elements into EU law. A key element is the so-called output floor. It is intended to prevent banks from using internal models to push their risk-weighted assets too far below the level that would result from standardised approaches. At the end of a transitional phase, this output floor will stand at 72.5% of the capital requirements that would apply if standardised approaches were used. According to the EU, this phase-in and other transitional arrangements are intended to ensure that the implementation of global standards does not lead to a weakening of the competitiveness of the European banking system.

The sensitivity of this balance is particularly evident in real estate financing. Europe has historically developed comparatively robust covered bond and mortgage systems, conservative lending practices, and close links between bank financing, the housing market, and the real economy. This on-balance-sheet lending system has proven its worth over decades and is a key component of affordable and well-established lending to the real economy. However, this also means that European banks are hit particularly hard by the Basel regulations, whereas in the U.S. the impact is significantly less due to the off-balance-sheet principle. Therefore, the greater alignment of internal models with the standardised approach means that in Europe, due to the output floor, well-secured portfolios that have historically often incurred few losses will in future sometimes require significantly higher capital backing than is appropriate given their actual risk structure. This makes loans more expensive and diminishes the ability to offer large-volume financing. Furthermore, this creates global disadvantages compared to competitors from other jurisdictions with less stringent or slower implementation, or where implementation is adapted elsewhere to the standard financing model of the real economy and private households, as will be the case in the US.

This is particularly problematic in the case of residential property loans. The EU itself has acknowledged that the blanket Basel approach does not always adequately capture the specific characteristics of national property markets. For this reason, CRR3 provides for transitional arrangements for certain low risk property loans. Unfortunately, this relief is only temporary. It does not address the underlying problem but merely postpones it: once the transitional phase expires, capital requirements are likely to increase, particularly for low-risk residential property loans. This makes housing construction and home ownership financing more expensive at a time when Europe needs more investment in housing.

Pressure is also mounting for commercial property financing and for project-based financing of property developments. Project financing has come under greater regulatory scrutiny and is subject to higher capital requirements. A risk weighting of 150% effectively places these loans on a regulatory par with the non-defaulted portion of a loan subject to impairment and has a prohibitive effect. This undermines the goal of improving the energy efficiency of the commercial property stock, as energy efficiency measures for these types of properties are often carried out as total refurbishments, during which no cash flow is generated from the property and a 150% risk weight looms. This prohibitive capital requirement disproportionately affects European banks, which have traditionally played a central role in financing long-term infrastructure, energy, and real estate projects. If the regulatory framework places an excessive burden on these transactions, it is not only the competitive position of the institutions that suffers, but also the investment capacity of the European economy. Here, too, it is evident that an insufficiently adapted implementation of the final Basel III requirements fails to adequately reflect the specific characteristics of the European on-balance-sheet financing model.

Another important area concerns the treatment of covered bonds. Covered bonds are a well-tested, crisis-resilient refinancing instrument, particularly in Europe, and are closely linked to property financing. Accordingly, Article 129 of the CRR provides for preferential treatment of covered bonds. With the introduction of the Covered Bond Directive in 2019, common minimum requirements for European covered bonds were established, thereby reflecting their high significance and quality.

Covered bonds are characterised through their dual recourse, strict legal requirements and ongoing special public supervision. They have been established in the market for decades, enjoy a high level of investor trust and represent a highly efficient source of refinancing, which in turn secures long-term, low-interest mortgage loans for European borrowers. If this quality is not consistently recognised in capital adequacy regulation, there is a risk of distortion at the expense of a particularly secure funding instrument that is central to European real estate financing. This would be a problem not only for banks but also for borrowers, as rising funding costs would translate into higher borrowing costs.

Preserving a robust covered bond market is therefore essential to safeguard affordable credit, reduce reliance on external capital markets, and strengthen the EU's strategic autonomy, competitiveness, and financial resilience. The importance of a regulatory and financial framework that supports this role of covered bonds is essential for sustaining Europe's growth and global competitiveness. A step in this direction is to ensure an appropriate adjustment to the risk weights and LGD values for covered bonds. An adjustment of the risk weights and LGD values for covered bonds would be fully justified given the low risk of covered bonds.

In addition to capital requirements, the European banking sector suffers from a second burden: an exceptionally high level of bureaucracy and reporting requirements. This diagnosis has long since ceased to come solely from the industry itself. In 2025, the ECB specifically established a High-Level Task Force on Simplification to develop proposals for simplifying the European regulatory, supervisory and reporting framework. The EBA has also addressed the efficiency of the regulatory and supervisory framework. When even the supervisors and regulators so clearly identify the need for simplification, it sends a strong signal: the density of regulation has reached a point where it is diverting resources away from lending, innovation and customer service. This bureaucratic burden is by no means a marginal issue. It ties up IT budgets, management capacity and specialist staff. It lengthens processes, makes products more expensive and reduces institutions' ability to react quickly to market changes. It thus acts as an additional implicit tax on the European banking business. In the context of global competition, this is particularly problematic because non-European competitors often operate with leaner reporting, auditing and documentation requirements. Those who have to write more reports, manage more data silos and meet more detailed regulatory requirements have less scope to grant loans, support customers and deploy capital efficiently.

It is not without reason that the importance of the so-called shadow banking sector has grown significantly in recent years. As always, capital seeks its own path and attempts to find regulatory loopholes. The rise of 'private debt' is a good example of this, and recent developments highlight the risks this poses to financial stability.

The consequence of this must be a clear political agenda.

Firstly, Europe needs genuine bureaucratic streamlining. This does not mean deregulation at any cost, but rather systematic proportionality: fewer duplicate reports, fewer redundant data requirements, fewer parallel audit processes and greater trust in proven internal banking control systems.

Secondly, there needs to be a reduction in capital requirements, particularly where European specificities and empirically low default risks exist. It is important to clarify that a selective adjustment of risk weights is needed and enhanced legislative simplicity need not entail a trade off with risk sensitivity or resilience. A robust and coherent banking framework can achieve several objectives, including simplicity, risk sensitivity and resilience. This applies above all to low-risk residential property loans, but also to certain commercial property financing and project financing. Thus, it is necessary to make the transitional arrangements under Article 465(5) CRR permanent at the current level for residential mortgage exposures and to extend the permanent treatment in Article 465(5) to commercial mortgage exposures. The output floor should be set at the original starting level of 50%. This would not overburden the banks while fulfilling its function as a backstop. When Europe wishes to deepen its Capital Markets Union, finance the energy transition and facilitate the creation of more housing, there is a need for regulation tailored to the European banking and financial system.

Thirdly, to preserve a robust covered bond market, Europe must ensure appropriate adjustments to the risk weights and LGD-values for covered bonds within the Credit Quality Step 1 in the standardised approach and IRB approach, respectively.

Ultimately, this is about more than just banking regulatory technicalities. It is about whether Europe continues to view its banks as key financiers of housing, small and medium-sized enterprises, infrastructure and transformation. If that is the case, then regulation is needed with a sense of proportion: robust, but not excessive; compatible with international standards, but not one-sidedly burdensome; security-oriented, but growth-friendly. This is precisely what is currently lacking in some areas. The threat to the international competitiveness of European banks is therefore real — and it is particularly evident in property finance. Anyone wishing to avert this must now act on three fronts simultaneously: reducing bureaucracy, calibrating capital requirements to be more risk-sensitive, and strengthening the regulatory treatment of covered bonds.