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The EU needs a balanced Basel III implementation

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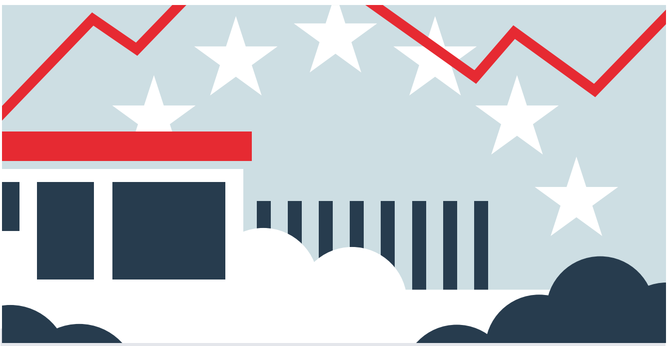
The EU needs a balanced Basel III implementation

EU mortgage markets are a cornerstone of the European economy. They are a key source of funding for EU homeowners and businesses, and they are paramount to post-covid-19 recovery. And not least, they play an essential role in the climate transition. Considering the war in Ukraine and the resulting energy crisis, this is more important than ever.

Therefore, the Basel III output floor, which has a disproportionately negative effect on the secure Danish mortgage loans, should be implemented in a balanced way to prevent any inadvertent impact on families, businesses, and potential renewed economic growth after the current crises.



Output-floor

The capital requirement determined using internal models to calculate risk exposures cannot fall below 72.5% of the capital requirement determined using the standardised approach

Mortgage markets are an important driver of the EU economy and the green transition

The key significance of mortgage markets to the EU economy can hardly be overestimated. At end-2019, outstanding mortgage loans in the EU amounted to almost EUR 8 trillion. This corresponds to almost 50% of the EU's annual GDP.

In addition to their role as a main driver of the EU economy, banks and mortgage lenders also provide finance to citizens buying homes and to SMEs stimulating investment and job creation. Their continued ability to channel funds to businesses and households is essential to the post-pandemic recovery of many EU member states.

Also, the financial sector plays a key role in the transition to a carbon-neutral economy. The war in Ukraine has highlighted the EU's strong reliance on fossil energy sources. This emphasises the need for an even faster and smoother climate transition. The output floor should therefore be implemented with caution to avoid any unreasonable and unjustified increases in capital requirements that would constrain banks and mortgage lenders' lending capacity.

Facts

Outstanding mortgage loans in the EU: about EUR 8 trillion – almost 50% of the EU's annual GDP.

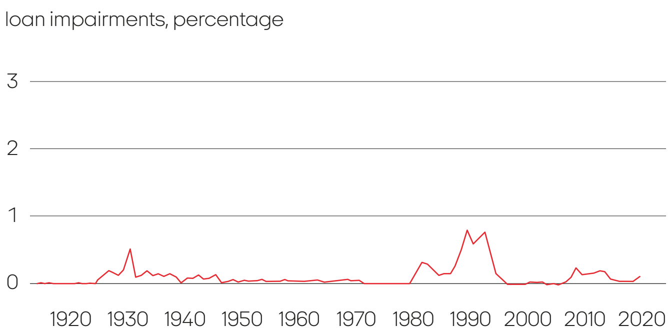
The need for housing renovation in the EU is substantial – 35% of the housing stock is more than 50 years old, and about 75% is not energy efficient.

New EU capital requirements are bad news to the EU's mortgage markets

The European Commission is rolling out new capital requirements for the financial sector. The requirements include the introduction of a global standard specifying how banks and mortgage lenders in the EU should calculate the amount of capital to hold for potential loan losses - the so-called output floor.

This means that many European banks and mortgage lenders will no longer be able to calculate the amount of capital required on the basis of internal loss data like they do today. Instead, all loans must be treated alike in the calculations. In other words, low losses and low risk will no longer equal lower capital requirements. This will take its toll on particularly the secure European mortgage loans – and customers. What makes European mortgage loans secure is the fact that they are secured by mortgage on the relevant property and that borrowers are personally liable for their loans – in other words as dual recourse. Consequently, over the past more than 100 years, losses on Danish mortgage

Danish mortgage loan impairments from a historical perspective



Source: Statistics Denmark, Kindleberger, Danish FSA, Association of Danish Mortgage Banks loans have been very low. From a historical perspective, annual loan impairments have averaged 0.10%.

The Commission's impact assessment estimates an overall average rise of 6.5-8% in the capital requirements for European banks. But increases will be much higher for mortgage loans/ mortgage portfolios.

Calculations[1] made for Danish mortgage loans show that the capital requirement for mortgage lending will rise by 36% relative to capital requirements already known. This effect does not allow for the Commission's temporary adjustments for home loans in output floor calculations.

This will force mortgage lenders to hold significantly more capital to cover potential losses than is warranted by the actual risk relating to their lending. And this comes at a cost: Investors demand interest to provide such funding. That will make household and business loans more expensive than necessary, to the detriment of homeowners and businesses. The output floor is the main reason for these increases.

Impact on Danish borrowers[1]

For a homeowner with a typical, fully mortgaged home and a loan of DKK 2 million, the additional cost will be DKK 4,400 a year before tax.

For an owner of agricultural property with a loan of DKK 6 million and an LTV of 60%, the additional cost will be DKK 14,500 a year before tax.

1 "The Final Basel III Standard And The Danish Mortgage Sector Impact on Danish mortgage banks and customers", Copenhagen Economics, January 2022.

The European Commission's solution is not sufficient

The Commission acknowledges the need for action in relation to the banks and mortgage lenders that will be hit disproportionately hard by the new requirements. The Commission has therefore proposed several temporary solutions, for instance an adjustment of the requirement for homeowner mortgage loans in output floor calculations.

This is a step in the right direction. But since these solutions are only temporary, they are not acknowledged by credit rating agencies, investors, and supervisory authorities. In practice, all mortgage lenders must therefore comply with the full implementation of the capital requirements already from day one, meaning that regrettably the solution proposed by the Commission will be of no real relevance to them.

Like the Danish government, the European financial sector is therefore striving, for instance through the EMF-ECBC , to ensure that the Commission's proposals are made permanent. The EMF-ECBC[2] is working to ensure that also business mortgage loans with a proven track record of low losses will be part of a permanent solution.

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[2] European Mortgage Federation - European Covered Bond Council

No adjusted treatment for mortgage loans

Concern is sometimes expressed over the idea of adjusting the capital requirement for mortgage loans in output calculations as proposed by the Commission. But this is fully justifiable. To benefit from the lower capital requirement, the loans will be tested intensely. For example, mortgage loan losses of up to 55% of property values must not exceed 0.25% of total residential mortgage lending on average over the past six years. Such testing provides an objective and satisfactory foundation for applying a lower capital requirement to residential mortgage loans in output floor calculations.

Finance Denmark
Amaliegade 7 · 1256 Copenhagen
Tel. 33 70 10 00 · www.finansdanmark.dk