

Implementation of Basel III framework into European Law

State of play, political discussions and economic effects

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Linea Søggaard-Lidell

- Member of the EP since 2020
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- ECON Political Advisor @ EP
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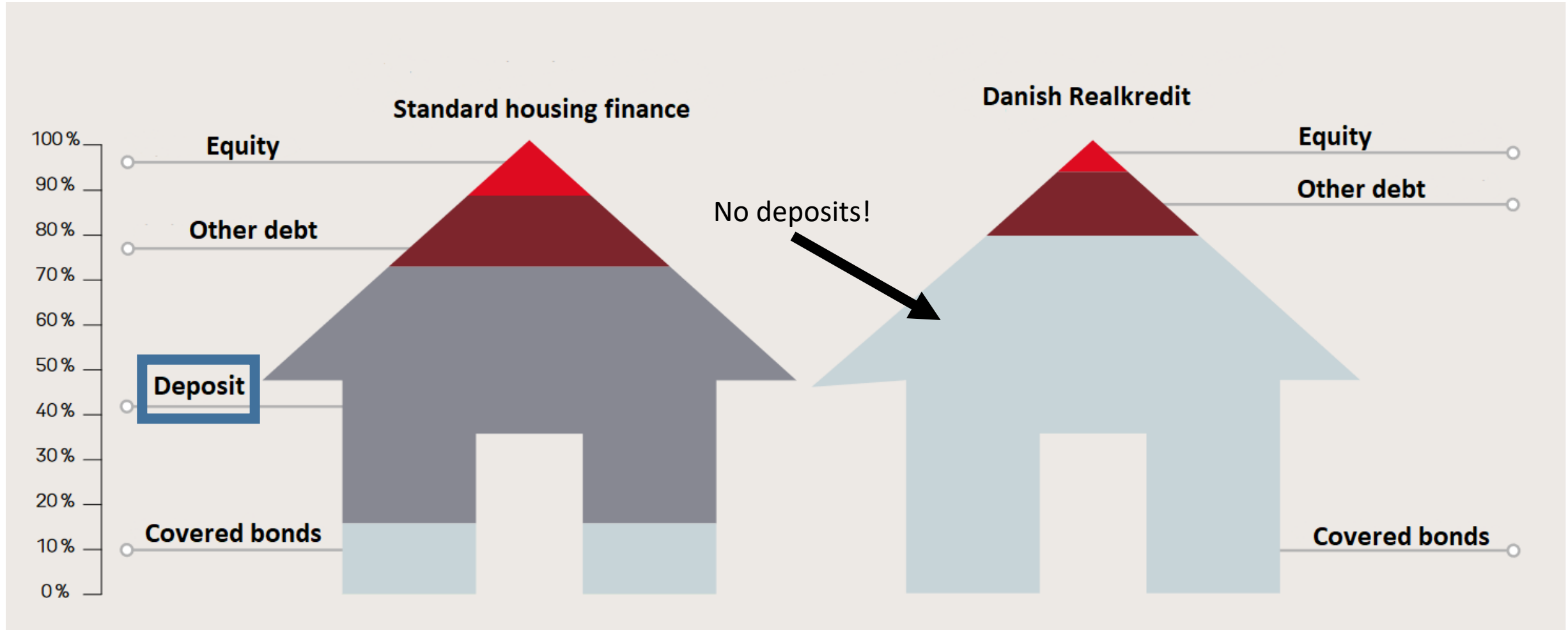
Agenda

- Quick recap of most important elements of Banking Package
- Analysis and expected impact of the proposed Output Floor on Danish mortgages and economy.
- The law-making process in the EP
- State of play of negotiations
- Q&A

Proposal for CRR3

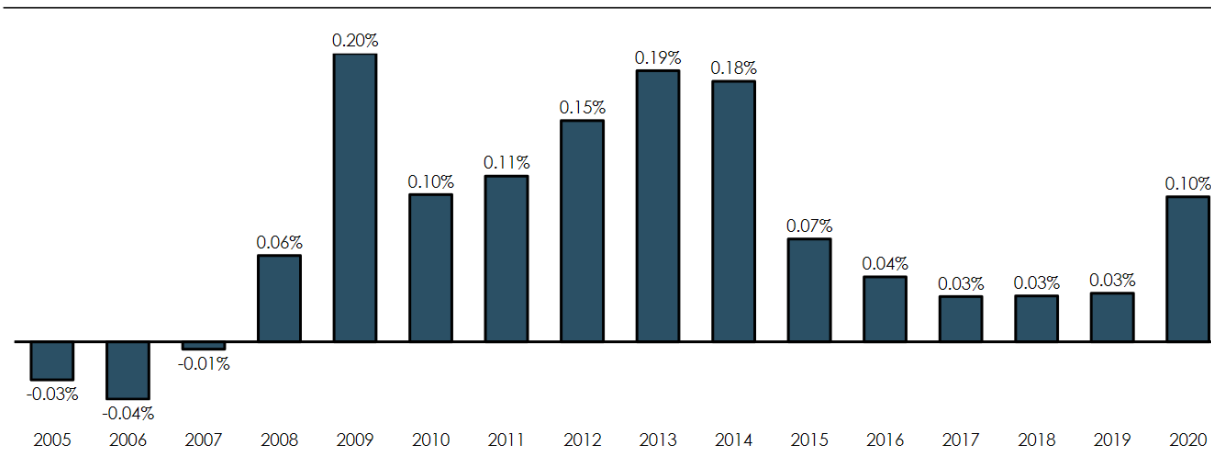
- An Output Floor(OF) is introduced...
 - With the purpose of addressing excessive risk weight variability among IRB models (model risk).
 - IRB RW are floored at 72.5% of SA
 - A temporary exemption is made for low-risk mortgages
 - 6 year average losses must not exceed 0.25%
 - No exemption for commercial mortgages – Danish specificity as well.

The Danish '*Realkredit*' Mortgage



No deposits = no bank runs = low risk

Total impairments of the Danish mortgage sector
Per cent of total lending



Source: Danish Financial Authority (2021), 'Markedsudvikling for realkredit'.

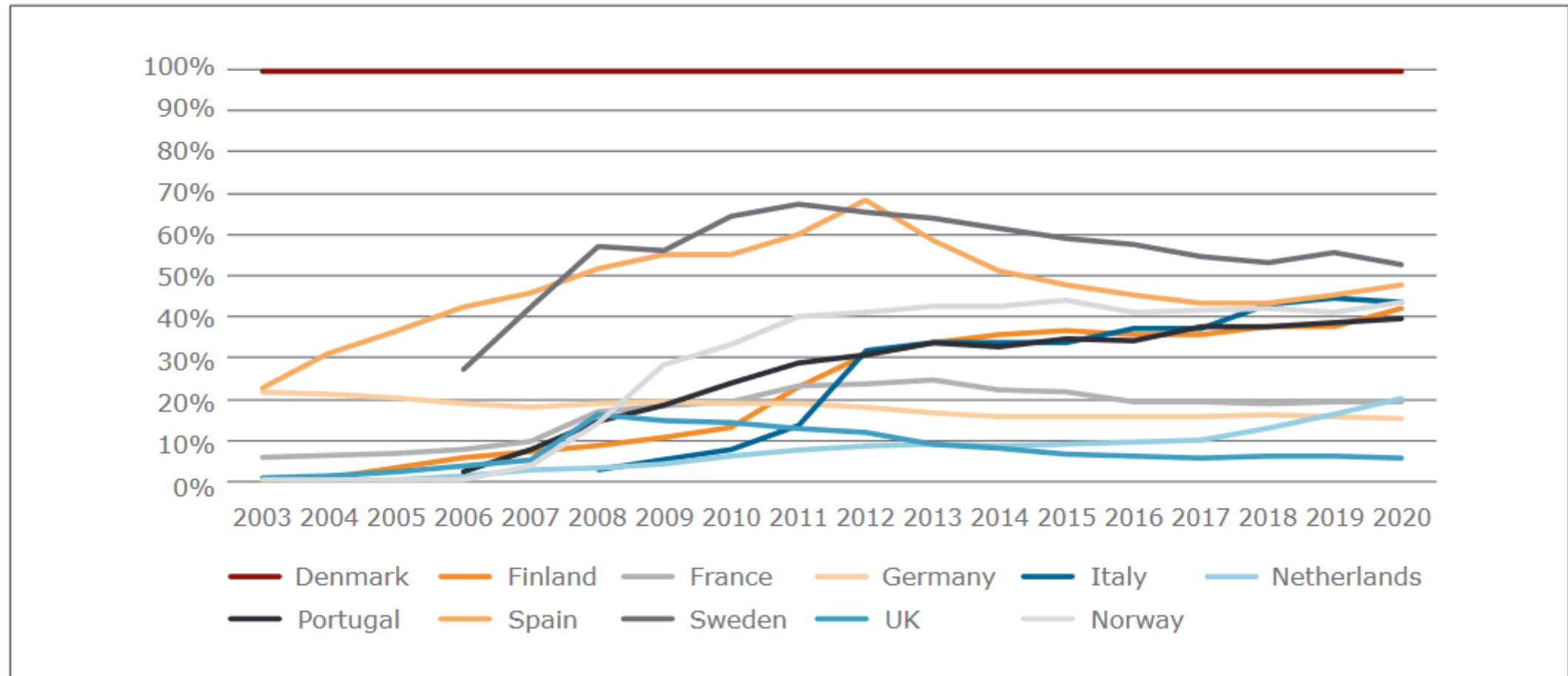


Features of Realkredit

- DK is the largest issuer of CB in the world worth €437,583 million \approx 15% of world CB.
- Danish CBs have the highest credit rating – comparable to sovereign debt
- Origins from 1795 when most of Copenhagen was burnt down.

A quite distinct Danish model..

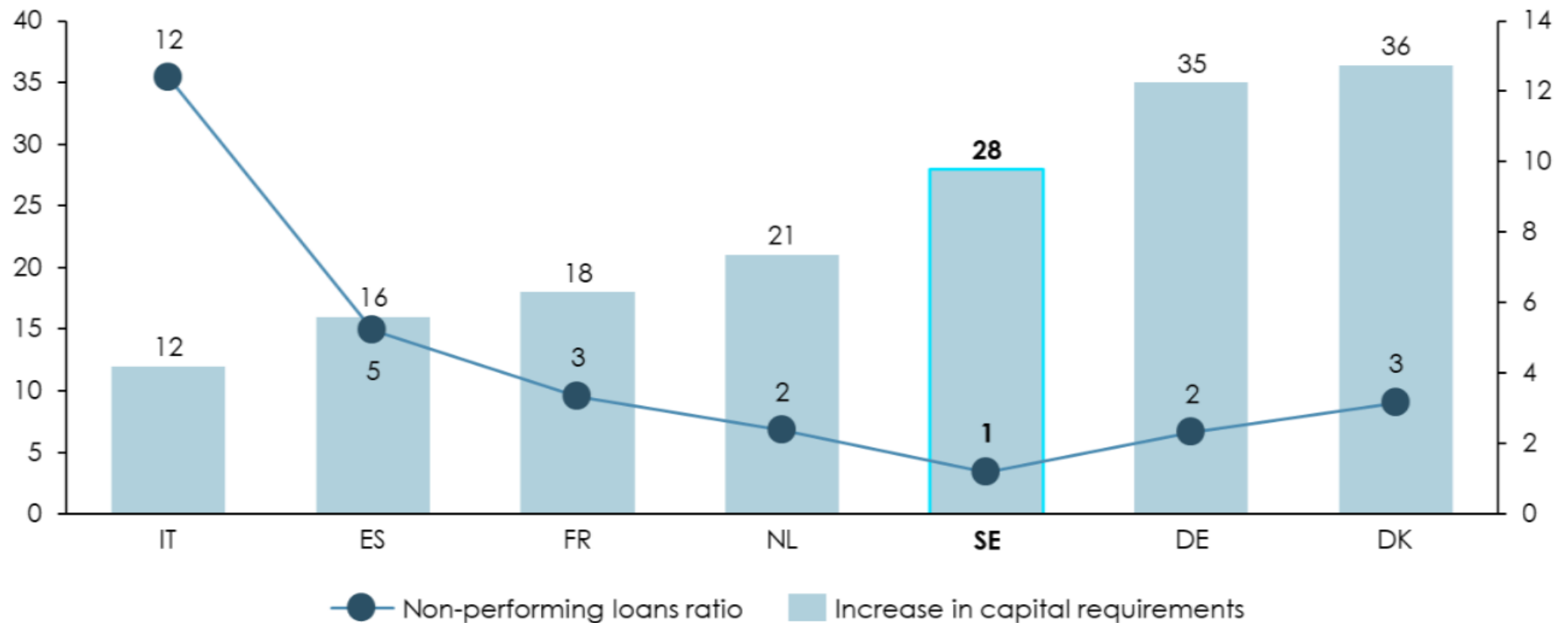
> FIGURE 2: MORTGAGE BACKED COVERED BONDS AS % OF RESIDENTIAL MORTGAGE LOANS



It is also an important political fight to fight..

Gross non-performing loans and increase in capital requirements

% increase in capital requirements (left axis), % of gross non-performing loans (right axis)



Mortgage financing in EU differs from US-financing

- EU's banks keep an overwhelming part of real estate finance on their balance sheets
- In contrast around 60% of US mortgage loans are transferred to or guaranteed by agencies, who only acquire low risk loans (max. credit score, max. debt-to-income ratio, max. amount)
- US Banks only keep 24% of mortgage loans on their balance sheets

- Therefore loans retained on US banks' balance sheets are generally of inferior credit quality
- The standardised risk weights for mortgage loans (20-30%) seem to be calibrated to US conditions
- Same seems to be true for corporate loans (100%) which are often secured by commercial real estate
- Level playing field between US and EU?

Holder 2019Q1	Million \$	Percent
Banks	2.595.575	24%
Government sponsored entities	6.755.760	61%
Others	1.553.664	15%
Total	10.904.999	100%

Source: <https://www.federalreserve.gov/data/mortoutstand/current.htm>

IRB approach risk weight under current standard	Europe	Americas
Retail residential mortgages	12.8	22.1
SME treated as corporates	46.2	74.7

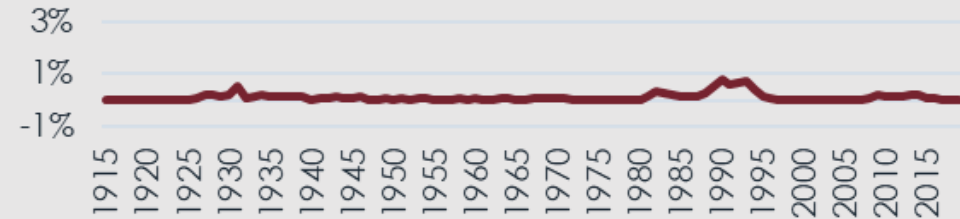
Source: Basel III Monitoring Report, March 2019, Table C.50

The output floor

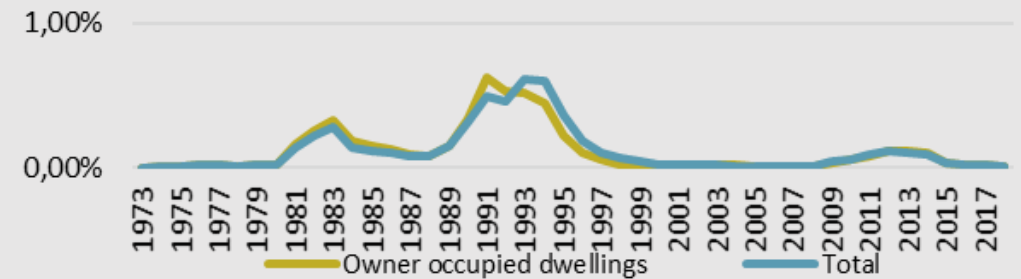
Permanent and extended solutions for low risk mortgage loans are fully justified – low loss rates on Danish mortgage loans

Well-functioning mortgage model in Denmark with low risk

Impairments on lending in Danish mortgage banks in a historical perspective



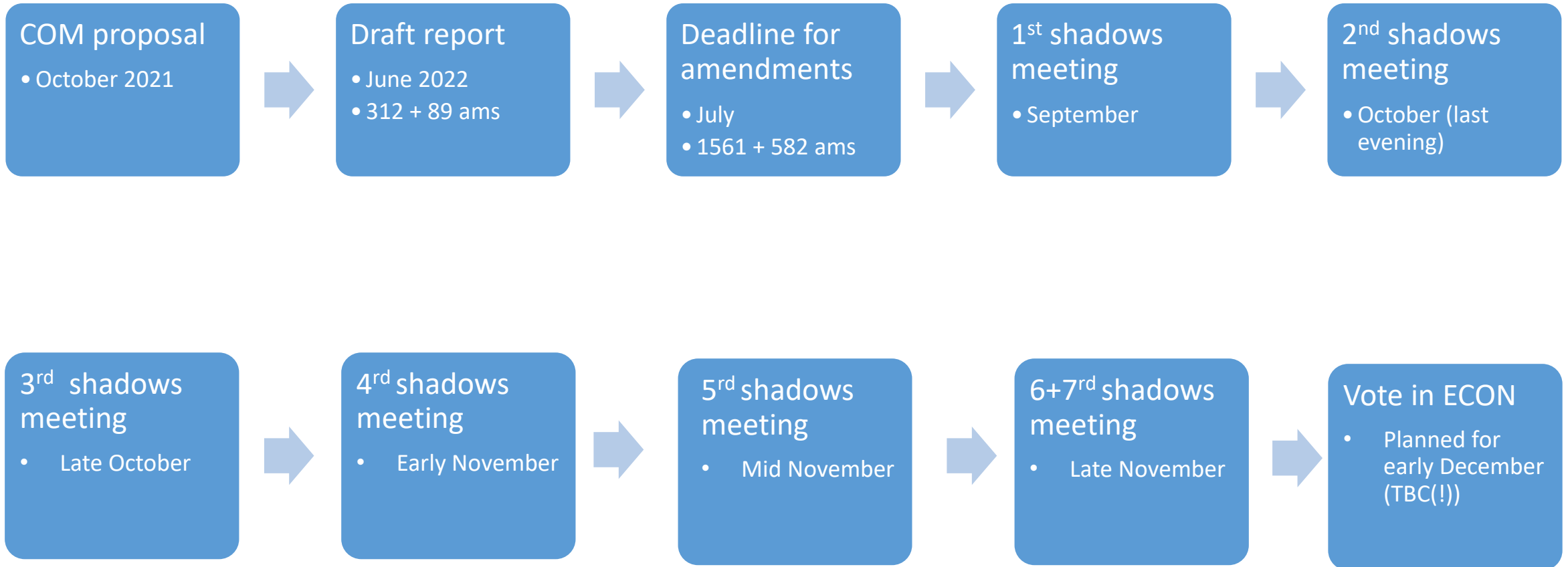
Source: Statistics Denmark, Kindleberger, Wikipedia, Danish FSA and Association of Danish Mortgage Banks.



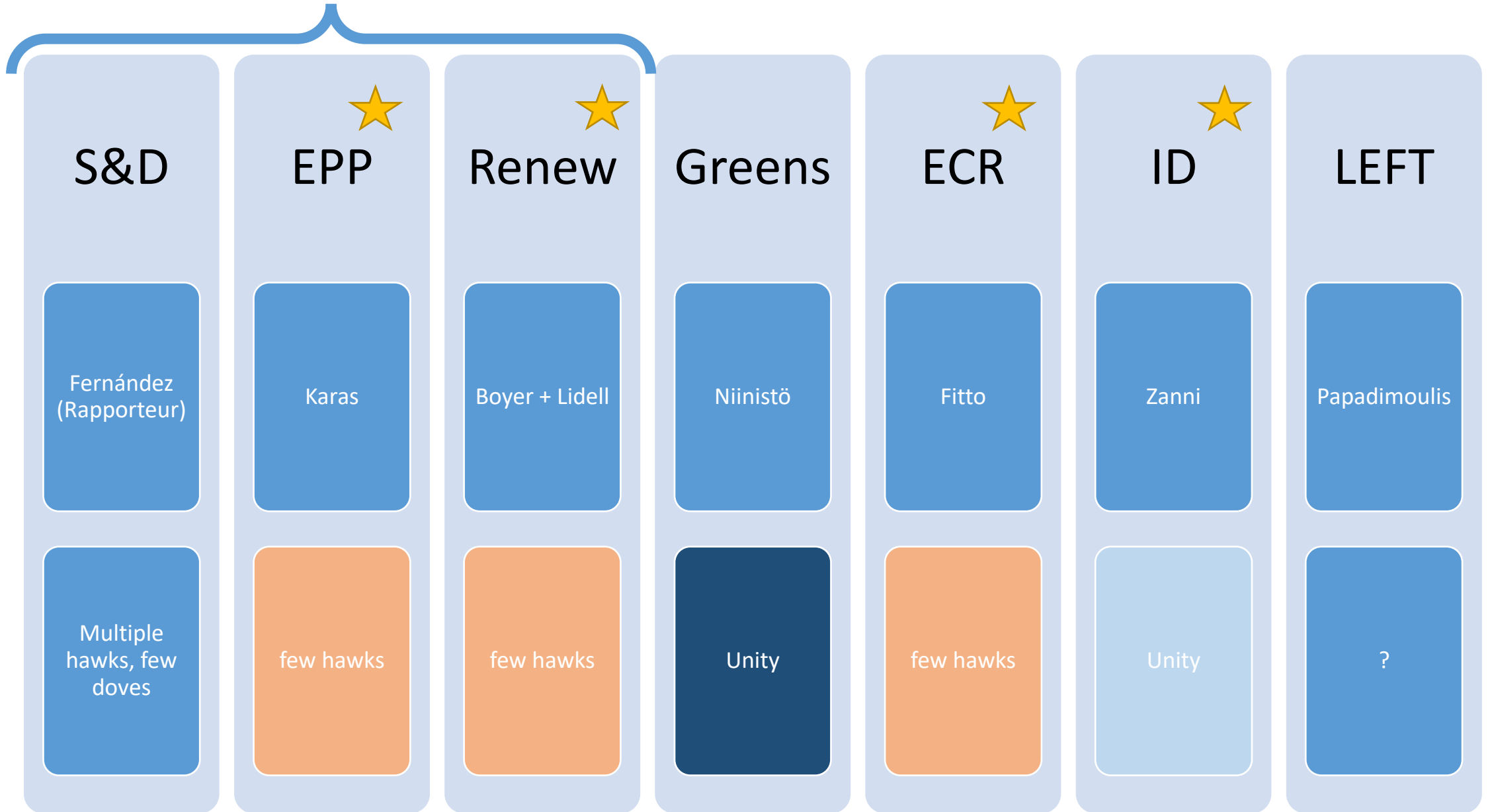
Annual loss rate (%) for exposures secured by commercial real estate	2014	2015	2016	2017	2018	2019
Lending up to 50% of market value	0.06	0.05	0.03	0.01	0.04	0.01
Lending up to 100% of market value	0.24	0.24	0.11	0.08	0.11	0.06

Source: Danish FSA

Process in the EP



VdL majority



State of play of negotiations

- First batch of compromise amendments include:
 - Transitional measures are kept (art. 465)
 - but..
 - for unrated corporates it is only for those with revenue of less than €500M
 - EBA mandate is deleted
 - Low risk mortgages need energy performance certificate of A+ or A
 - EBA mandate is deleted
 - level of application made dependent of evolution of Banking union including EDIS.

State of Play (continued)

- Work until next meeting.
- ‘What criteria should be justified for extending the transitional arrangements?’