# The New Capital Adequacy Rules – Impact on Covered Bonds

Tuesday, 14th October 2003

# Introduction

# European Mortgage Federation

- European association founded in 1967
- Represents the interests of mortgage lenders
- Brings together mortgage lenders from all European countries plus Norway and Switzerland
- Accession countries membership: Romania, Czech Rep., Hungary, Malta, Poland & Latvia
- Represents over 75% of EU mortgage market

# Europe

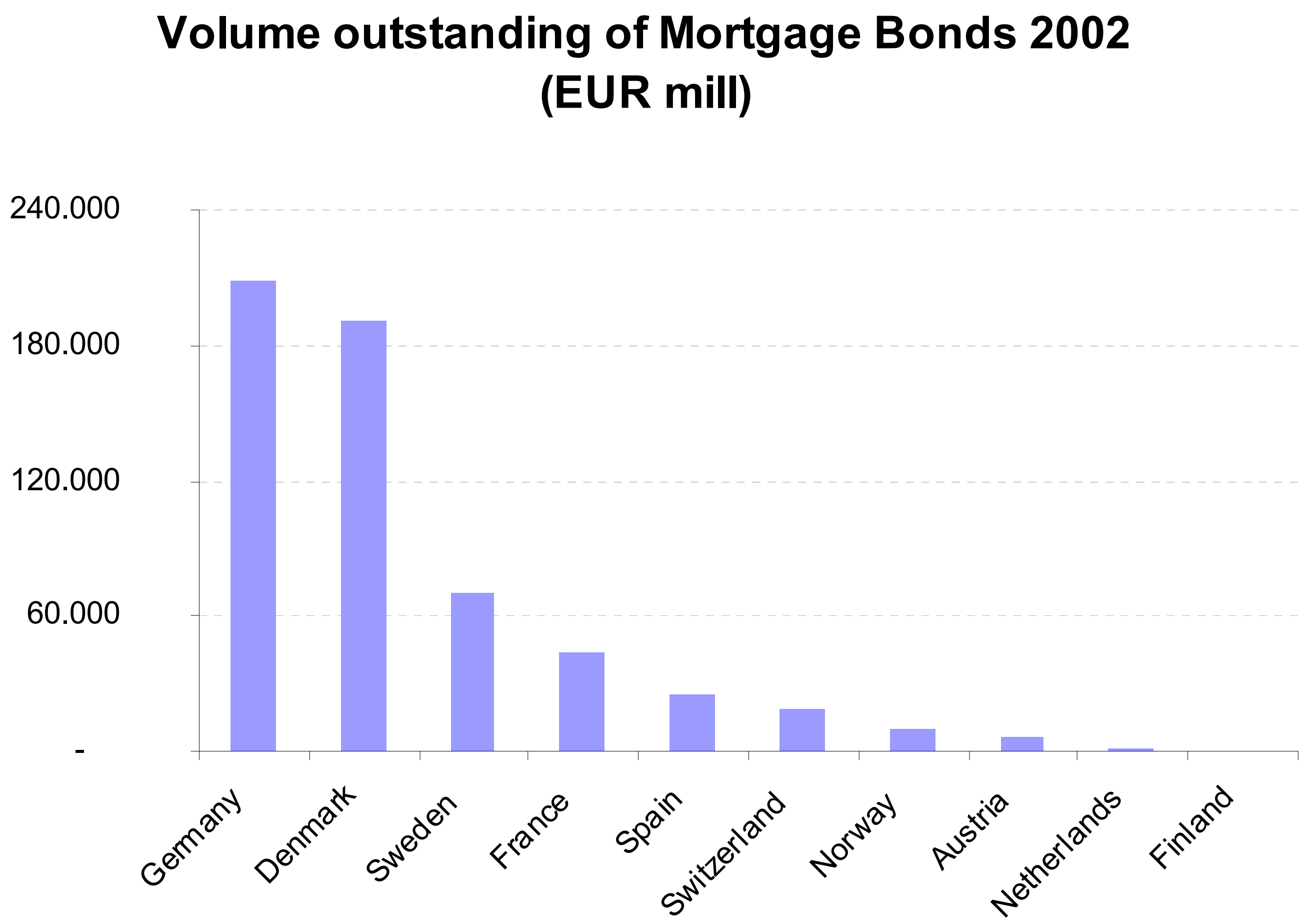

Greenland
Iceland
Faroe Islands
Finland
Norway
Sweden
Russia
Scotland
Estonia
Ireland
Denmark
Latvia
Lithuania
Wales
England
Belarus
Netherlands
Poland
Belgium
Germany
Luxembourg
Czech Rep.
Ukraine
Liechtenstein
Slovakia
Switzerland
Austria
Hungary
Moldova
France
Slovenia
Romania
Croatia
Monaco
Yugoslavia
Portugal
Andorra
Italy
Georgia
Bosnia
Bulgaria
Holy See
Armenia
Spain
Macedonia
Azerbaijan
Albania
Greece
Canary Islands
Malta
Cyprus

# Mortgage bond market in Europe

# Mortgage Bond Market in Europe

- EMF estimates c. 20% of total volume of residential mortgage loans is funded through issuance of mortgage bonds (end of 2002)
- Outstanding volume of mortgage bonds in 2002 was EUR 1.5 trillion
- Mortgage debt accounts on average around 40% of European GDP
- The household debt relative to nominal disposable income increased in all countries
- Mortgage bond market in Europe is highly concentrated
- Main markets: Germany , Denmark , Sweden

# Outstanding Volume of Mortgage Bonds (2002)



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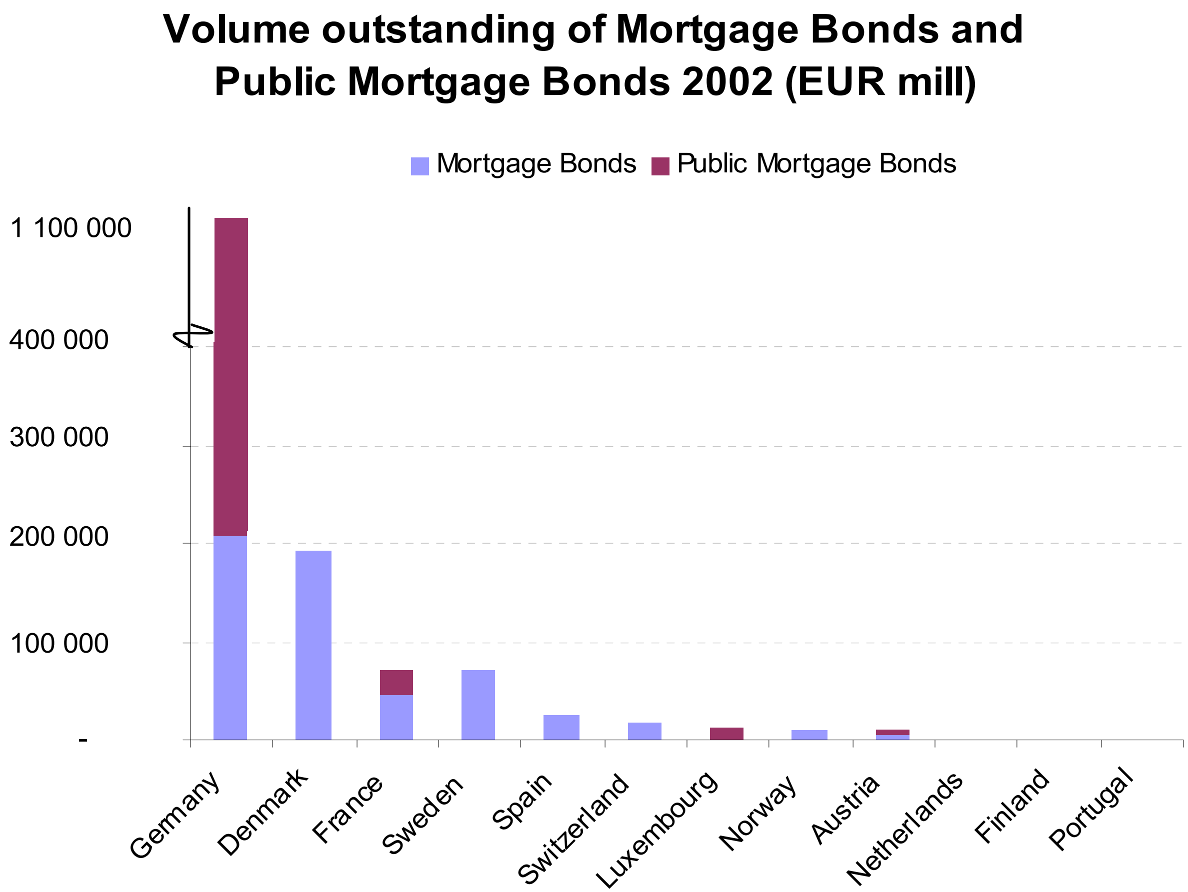
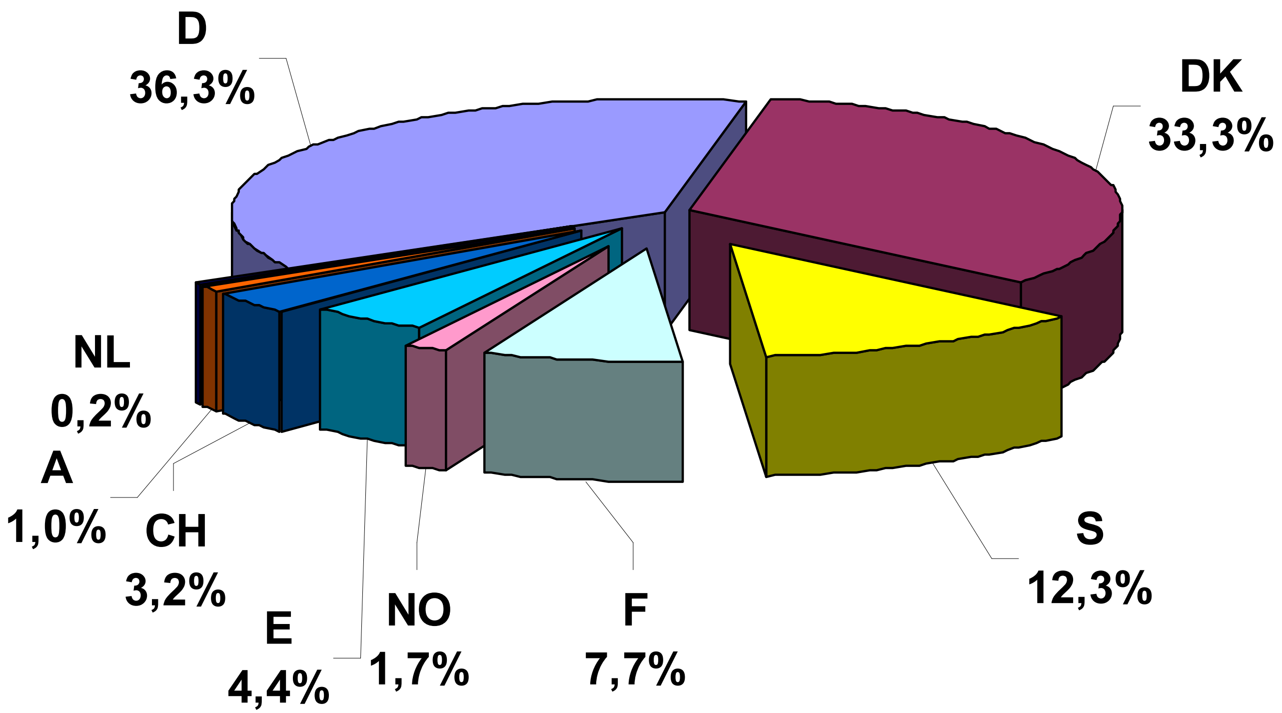


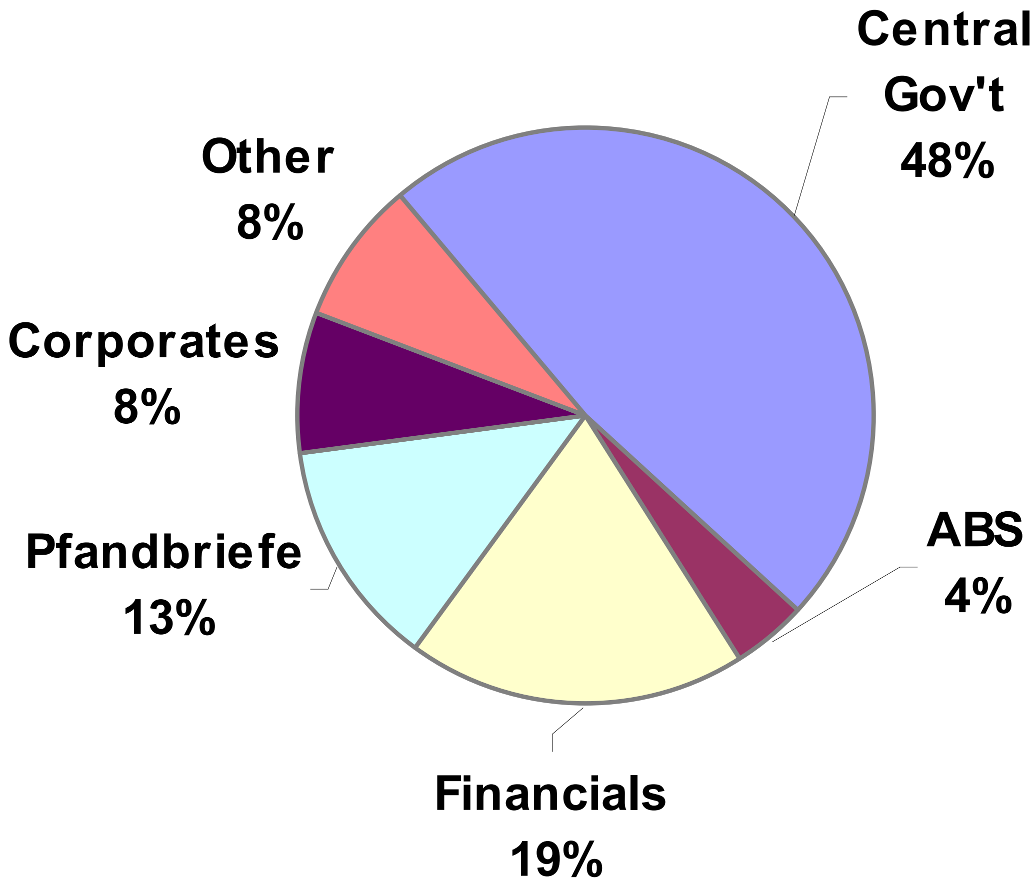

**Source: European Mortgage Federation**

# Share of Outstanding volume of mortgage bonds (year 2002)




*Source:* European Mortgage Federation and national sources

# Gross issuance in the euro-denominated bond markets (2002)




Source: European Commission

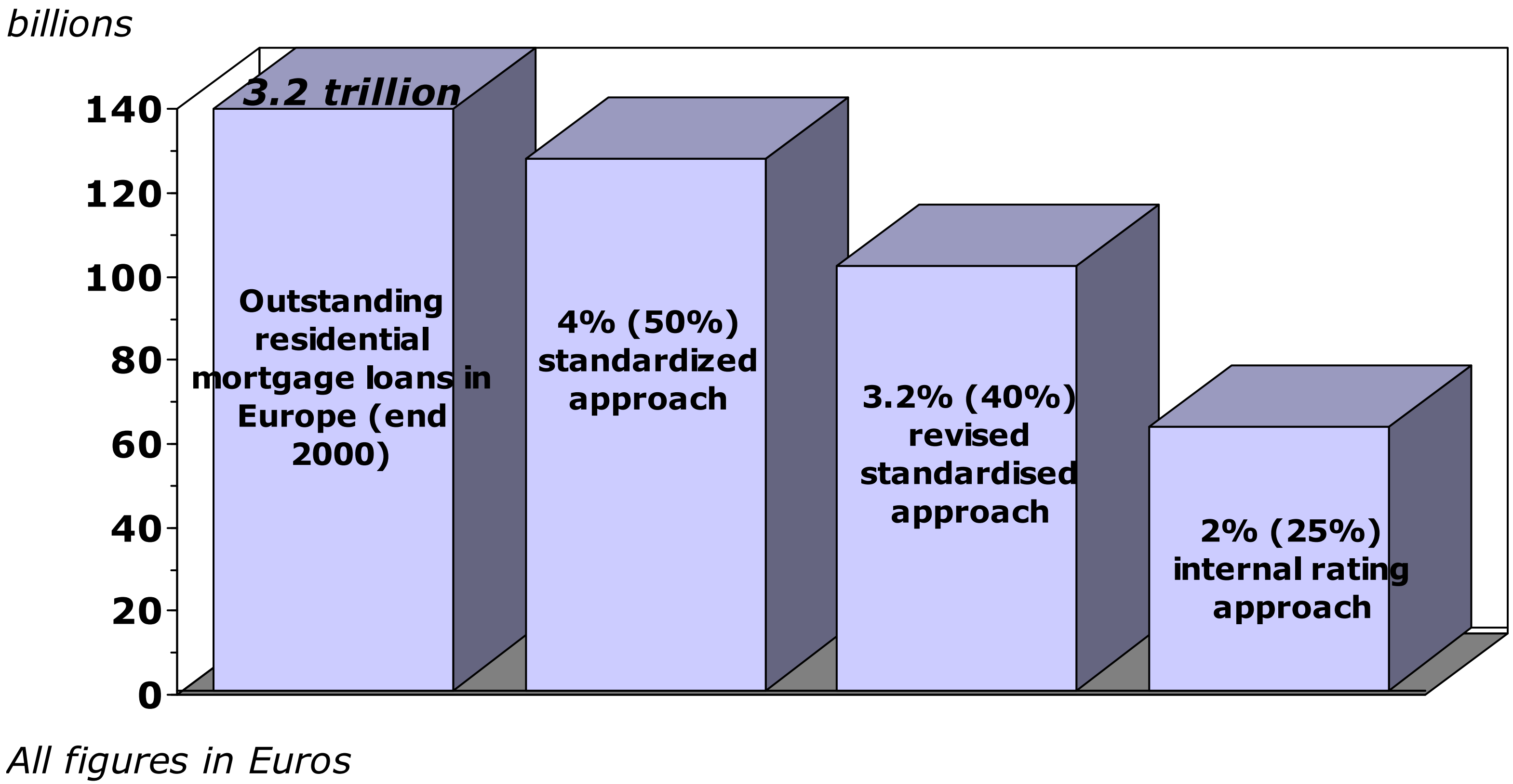
# Bank Capital Adequacy Requirements

- Portfolios
- Covered bonds

# Standardised Approach

- Risk weight for **residential real estate** loans fully secured to be reduced from 50% to 35%
- Risk weight for **commercial real estate** loans to be reduced from 100% to 50%
- Standardised approach is modelled closely on existing credit risk framework
- Proposal to introduce 75% risk weight for retail loans

# Potential savings from IRBA



# Capital requirements for Covered bonds

- Covered bonds play a significant role in the European capital markets
- Under current Directive, covered bond are risk-weighted at 10%, subject to conditions laid down in Art 22(4) of UCITS Directive
- The Commission Services have developed a proposal for the treatment of covered bonds under the Standardised and Foundation IRB Approaches

# Weighting for covered bonds

- The Commission proposes the following weightings for covered bonds:

| REVISED STANDARDISED APPROACH (RSA) | FOUNDATION IRB APPROACH | ADVANCED IRB APPROACH |
|---|---|---|
| ▪Separate risk weights for covered bonds<br>▪Typical weighting of 10% | ▪Institutions use supervisory estimates of LGDs and/or EADs<br>▪Typical estimated weighting of around 8% with PD of 0.1% | ▪Banks will determine their own capital requirements<br>▪Typical weighting <8% |

# Treatment of covered bonds under RSA

- Under RSA, capital requirements are linked to external rating grades of the issuer
- The Commission grants covered bonds a risk weighting one notch lower than issuers of unsecured lending, i.e.
  - a 10% risk weight for covered bonds issued by an institution with unsecured debt risk-weighted at 20%
  - a 20% risk weight for covered bonds issued by an institution with unsecured debt risk-weighted at 50% (below AA-)

# Internal Ratings Based Approach

- IRB Approach reflects more closely institutions' actual exposure to credit risk
- The Commission applies to covered bonds the risk weight function that is generally applied to risk weight exposures to institutions (PD, LGD, etc.)
- All institutions have to **internally** estimate the probability of default (PD) of their borrowers
- Other risk parameters used: loss given default (LGD), exposure at default (EAD)
  - **Foundation IRB**: use of standard estimates; avg. maturity of 2.5 years applies to all exposures; the supervisory LGD is set at **20% for all covered bonds** (vs. 45% LGD applicable to the credit institution's unsecured debt)
  - **Advanced IRB**: use of own estimates of LGD; explicit maturity of an exposure has to be used

# The Commission's CP3 approach for covered bonds

- Third Consultative Paper (CP3) in July 2003
- Review of capital requirements for banks and investment firms
- View to implementing Basel II new accord 2006/2007
- The Commission proposes eligibility criteria for covered bonds

# Eligibility criteria

- In its CP3 paper, the Commission restricts eligible assets to the following:
  - Loans to sovereigns, central banks, international organisations, regional governments, local authorities, administrative bodies and non-commercial undertakings that qualify for a 20% weighting
  - Loans secured by residential real estate up to 80% LTV
  - Loans secured by commercial real estate up to a 60% LTV
  - Exposures to institutions that qualify for a 20% weighting being allowed as substitution assets up to 5% of the covered bonds outstanding

# Current status

- Federation is responding to Basel II consultation paper no. 3
- The EMF is trying to obtain representative LGD figures from European mortgage industry to show the Commission LGD figures are substantially lower than 20%

# Final remarks

- New rules on the weighting of mortgage portfolios (both residential and commercial) are welcomed by the industry
- Our focus now is on mortgage bonds and securitisation
- Concerning mortgage bonds, the industry welcomes Commission′s efforts to find appropriate weightings
- However, covered bonds are hybrid instruments and are difficult to classify in the Basel approach
- In addition, there is a not enought data on loss rates for covered bonds which does not allow the allocation of appropriate LGD‛s
- Discussions as to whether the Commission should foster more uniformity of the secondary mortgage market by helping funding instruments (today, over 60% of Europe′s mortgage loans are funded through deposits)