German Property Federation

POSITION PAPIER

Basel III Implementation in the European Union

per 15 November 2022

Executive Summary

The draft adopted by the European Commission to implement Basel III regulation will inevitably lead to more difficult financing conditions for the real economy. Although the proposal contains isolated improvements compared to the original package of the Basel Committee, these are insufficient to cushion the negative consequences for the real economy. The present package leads to strong consolidation effects in the banking sector and to burdens for certain segments such as the financing of project developments.

In particular, the consistent implementation of the so-called output floor will cause additional capital requirements for banks. This primarily affects credit institutions that use internal risk calculation models, mainly large banks. Although many stakeholders advocated early on for the application of a "parallel stacks approach" to prevent gold-plating by taking into account additional European capital buffers, this proposal was not adopted. Admittedly, the European Commission has promised to temporarily "freeze" individual capital buffers such as the Pillar 2 requirements and to review them in principle. However, it is more than questionable whether this measure can compensate for the negative effects of the output floor.

According to estimates by the European Commission, the new requirements will increase the minimum capital requirements of European banks by an average of 6.4 to 8.4 percent by 2030. In the medium term, i.e. until 2025, the additional capital requirement will be even lower at 0.7 to 2.7 percent. However, individual institutions and regional financing markets in particular (such as German credit institutions) will be significantly more affected by minimum capital increases.

Due to the said weak points of the draft, further improvements in the legislative process are necessary.

Major concerns

1. **Output-Floor**

Despite the above, the European Commission has decided to consistently implement the output floor for banks that use internal risk calculation models, as envisaged by the Basel finalisation package, even though other options are available. At the same time, the European Commission considers the Pillar 2 requirements (P2R) and the systemic risk buffer (SyRB) as vehicles with which risks can be equally absorbed, as is also intended by the application of the output floor. Thus, there is a possibility that risks are taken into account twice by application of the output floor. Supervisors should therefore review the requirements for P2R and SyRB when the output floor is applied. According to the European Commission, the requirements for P2R and SyRB should be frozen in order to prevent an automatic increase triggered by the output floor. The requirements are to be reviewed and, if necessary, adjusted.

However, it is difficult to imagine that the supervisors will actually make material reductions, regardless of certain CRD requirements. The discretionary leeway of the supervisory authorities is still too great for that. Moreover, it is not defined which components exactly are considered as "double-counting" and which share of this could be used as compensation mass.

It is regrettable that the European Commission has spoken out against the application of a "parallel stacks approach". By applying the output floor to all legally prescribed capital buffers, including those specific to Europe, the European Commission goes beyond the requirements of the Basel finalisation package. This leads to an additional and unnecessary burden for credit institutions.

2. **Entities without external Rating**

The problem of non-existent ratings in Europe has been recognised. A transitional period will allow credit institutions to apply a preferential risk weighting of 65% to loans to unrated entities, assuming the probability of default is below 0.5% (investment grade rating). The transition period will last until 2032. This is intended to create the possibility that external ratings for a large number of European companies will be created in the future through public or private initiatives.

Since this is a temporary solution, this option is insufficient. What is needed is an identical, permanent regulation that also applies after 2032, and this to all types of credit, including loans secured by real estate. The current reading of the Commission proposal leads to the conclusion that the temporary regulation for entities without external rating only applies to classic corporate financing, and that loans secured by real estate do not benefit from it. Moreover, the temporary regulation will expire exactly when the output floor will have its full effect and ultimately lead to an additional burden in combination with the lack of ratings. Due to the high costs, SMEs in particular will have to do without an external rating in the future. This will cause lasting damage to Europe as a business location.

3. Income Producing Real Estate (IPRE)

IPRE primarily affects real estate financing for which the ability to repay is based on income from rents, etc. This is not the case with many real estate financing models in the European Union, but rather with many real estate financings in the office, hotel or apartment building sectors. According to Basel, these loans are considered riskier and are to be backed by a higher risk weighting. According to the Commission proposal, this general risk weighting is to be relativised by more granularity. If the supervisory authorities of a member state can prove on the basis of historical data (so-called hard test) that certain loss rates have not been exceeded. Accordingly, loans to IPRE would have to be treated like ordinary real estate financing and backed by the corresponding risks. This applies to both residential and commercial real estate financing, whereby commercial real estate must be weighted with a higher risk (60%) than residential real estate (20%) via the loan-splitting approach. This step is to be welcomed, but an unequal treatment of residential and commercial real estate can also be observed here, so that a balance must be created. In addition, exemptions for residential property financing are for the most part only provided for cooperative and public housing. We support an extension to "subsidised housing". In times of discussion on affordable construction and housing, market-inhibiting measures have a counterproductive effect and further aggravate the already precarious situation in urban areas – with all economic and political consequences.

4. Financing land acquisition, development or construction (ADC)

In the context of the Basel III publication, the introduction of the new asset class for land purchase financing for project developers was strongly criticised. The introduction was associated with an across-the-board increase in the risk weighting from 50% to a speculative 150%. This affects both land for residential and commercial real estate. The European Commission's draft allows for a reduction to 100% for residential real estate projects if one of the following risk-minimising factors can be demonstrated:

- legally binding pre-sale or pre-let contracts, for which the buyer or tenant has paid a substantial cash deposit that will be forfeited if the contract is terminated, make up a substantial part of the total contracts;

- the borrower has substantial equity that is appropriately included in the appraised value of the residential property at completion.

The EBA is required to define what constitutes substantial equity, for example, one year after the new rules come into force.

Despite small corrections, the ADC risk weighting is still too high, it applies exclusively to residential real estate projects and is tied to certain criteria, which could ultimately burden and even prevent the financing of project developments, especially commercial real estate projects. The financing of such projects could go through alternative, unregulated financiers and inevitably lead to a higher risk for the stability of the financing sector.

5. Stronger risk sensitivity in LTV calculation

Contrary to the Basel III standards, interim increases in the value of real estate are now taken into account when calculating the risk. Here, corresponding average values can be formed (last three years for commercial real estate and last six years for residential real estate). It is positive that the value cap "at origination" was not implemented, but that the value may increase at least "as a moving average".

6. Transitional relief for residential real estate financing

If residential real estate financing is secured by a mortgage, it can be assessed with a preferential risk weighting. The EBA will set up a monitoring system and report after the transitional period whether the preferential status of residential real estate financing is maintained. As this is also only a temporary regulation until the end of 2032, further improvements are necessary in order to implement permanent solutions.

7. New capital requirements for participations in real estate funds

Within the scope of the CRR amendment, real estate funds are already burdened with noticeably higher capital requirements with the effectiveness of CRR II than in the previous regime. Under the CRR III regime, there is a threat of new capital requirements for units in investment funds (undertakings for collective investment - UCIs), which will lead to significantly stricter capital adequacy requirements in connection with real estate funds.

Since the regulations of the CRR II regime came into force, the transparency approach has been predominantly used for the calculation of capital requirements. This provides for a fund review and capital adequacy according to the fund components; i.e. the positions acquired indirectly via the UCI are equated with the direct positions of the bank. For real estate funds, a distinction must be made in the look-through as follows: If the fund contains only real estate, the risk weight of other positions/property, plant and equipment (100%) will be applicable. If the fund holds the real estate via a special purpose vehicle (SPV), the risk weighting for participations (250%) will apply.

An example calculation from a real estate portfolio shows how dramatic the additional burden of CRR III would be:

Previous RWA before CRR II:	75.2 million (RW 92.9%)
RWA after CRR II:	105.6 million (RW 130.5%)
RWA according to CRR III:	135.4 million (RW 167.3%)

The use of so-called special purpose vehicles is not uncommon in the fund industry. However, this use is not associated with any increased risk, so that the blanket increase in the risk weighting is unjustified. This is because in real estate funds, the properties are usually held by real estate subsidiaries of the fund, in which the fund holds a 100% stake. The main risk of these real estate subsidiaries is the underlying properties. In this way, the risk is no different from the ownership of the property itself, which as an asset would receive a risk weighting of 100%.

About ZIA

ZIA German Property Federation is the leading professional association and the regulatory and economic lobby for the entire German real estate industry. It has its headquarters in Berlin and a representative office in Brussels and country offices in Austria (from January 2023) and Switzerland.

With more than 300 members, including 30 associations, it speaks for around 37,000 companies in the sector along the entire value chain.

As a federation of entrepreneurs and associations, the ZIA gives the entire German real estate industry a voice at national and European level. Their diverse interests are represented by unified, inclusive positions that reflect the importance of the industry for the national and European economy and for achieving the goals of the Green Deal. In Brussels, we also maintain an ongoing dialogue with other European and national associations from the sector and beyond.

With more than 800,000 companies and around 3.5 million employees, the real estate industry is one of the largest and most dynamic economic sectors in Germany. With more than 645 billion euros, it contributed more than 20 percent to the total gross value added in Germany in 2021 and thus significantly more than other sectors, such as vehicle manufacturing.

The industry is aware of its responsibility in the fight against climate change and has reduced its annual CO_2 emissions from 210 to 115 million tonnes per year between 1990 and 2021. Digitalisation is also of particular importance in this context, which is being driven forward not least by various start-ups bundled in the ZIA PropTech platform. To this end, the ZIA is also intensively involved in the New European Bauhaus initiative as well as in different European policy debates including financial services.

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