EU bank regulation: Throwing out the baby with the bathwater?

By Jens Tolckmitt, CEO, Association of German Pfandbrief Banks, vdp, Berlin

Bank regulation is also a concern for many real estate investors, if indirectly. Real estate lending generally involves high loan volumes and these – if secured by first-ranking liens – involve little credit risk for the banks. Yet it is precisely in these areas that current regulation proposals could – if enacted – throw out the baby with the bathwater. Real estate lending is also long-term: regulation that will enter into force in several years already affects today's lending. We may yet witness regulation-induced credit restrictions that we have not yet experienced. There have been numerous and far-reaching regulatory initiatives also concerning real estate lending that are currently in the implementation stage with technical standards being developed. They include Basel III, known in Europe also as Capital Requirements Directive (CRD IV). The Directive on Credit Agreements relating to Residential Property (CARRP directive) has been agreed upon and is being enacted.

Jens Tolckmitt: "An even stricter leverage ratio will mean that banks using internal ratings for their risk-weightings will need more own capital for their lending."

Unfortunately, the European Commission has wasted no time waiting for the considerable impact these new regulations are bound to have. In February 2012 it asked a High-level Expert Group (HLEG) chaired by Erkki Liikanen to assess what additional regulatory reforms were needed to establish a safe, stable and efficient banking system in Europe. The HLEG report published in October 2012 included numerous proposals. Three relate directly to real estate lending:

Leverage Ratio: The HLEG endorses the leverage ratio that will be introduced by the CRD, asking "whether the requirement […] is sufficient." This is a particular concern for real estate lending, as an even stricter leverage ratio will mean that banks using internal ratings for their risk-weightings will need more (expensive) own capital for their lending. This will make especially residential real estate lending or lending at higher LTVs more expensive. Banks not being able to acquire even more own funds – and the CRD already asks for considerably more – may even refrain from further lending in this competitive segment altogether.

More Robust Capital Requirements for Real Estate Loans: The report suggests that banks using an internal approach to risk-weigh their assets are not putting enough capital aside for the event of substantial property market stress. It recommends 'robust' floors for these risk-weighted assets. However, current regulation regarding internal risk models ensures that these are already risk-sensitive and take national real estate market structures into account. Once the Capital Requirements Regulation is in force, the favorable risk rate given to secured real estate lending will only be granted if data on loss experience collected by supervisory authorities would argue for such a privilege. The HLEG does have a point: In some European countries, risk models used by banks in real estate lending were too lax. Yet it would be absurd to make banks and in consequence customers in safer (less volatile) markets pay more because of past irrational exuberances in other European markets.

LTV/LTI limits: To "limit the risks stemming from real estate markets" the HLEG advocates 'strict' caps on loan to value- and/or loan to income-ratios in lending. Admittedly, there have been lending practices in the past that could not have been called responsible – or even sensible. Strangely, while the CARRP directive was and is quite elaborate in addressing that problem, the HLEG makes no mention of it at all. It would be short-sighted to introduce these caps, because these ratios are only two measures to gauge the riskiness of the loan. Banks have a vital interest to engage in loans that perform. Caps on lending would make affected customers look elsewhere for funding. This would make real estate markets less secure, not more.

Safer banks and sounder real estate markets are goals worth fighting – and regulating – for. However, some of the Liikanen group's suggestions could be counter-productive on both counts. ■ **jt**

Jens Tolckmitt can be reached at tolckmitt@pfandbrief.de