Mortgage Lenders and the New Basel Capital Accord

by David Manning

THE NEW BASEL CAPITAL ACCORD

At the end of 2001, the total volume of outstanding mortgage loans in the European Union exceeded 3.9 trillion euros. This amounts to around 40% of total bank lending in Europe and 40% of E.U. gross domestic product. Over 95% of these mortgage loans are kept on banks' balance sheets, which is why the treatment of mortgage portfolios in the new Basel Capital Accord is so important for European mortgage lenders.

In contrast, in the United States the majority of mortgage loans are held off-balance sheet and funded through securitization. In the U.S., much of the credit risk is transferred to non-banks (insurers and government-sponsored enterprises).[1] Funding is provided as much—if not more—by banks and savings and loan associations (thrifts) through their agency debt and holdings of mortgage-backed securities.

These different mortgage banking models are undoubtedly a factor in the different perspectives between the U.S. and Europe on the ongoing review of capital adequacy rules.

The 1988 Basel Capital Accord's—the old or current Accord—main value added has been the simplicity and ease of use of its standardized approach, the 8% capital requirement (and 4% for residential mortgage loans). For some time, however, mortgage lenders in Europe have recognized that the old Accord no longer met the needs of increasingly sophisticated financial markets and the participants in those markets. New technology, globalization, innovative financial products and services have changed the way markets operate and the way banks measure and manage credit, market and operational risks.

Unsurprisingly, mortgage lenders are not alone; regulators and supervisors are also aware of the enormous changes in financial markets since the old Accord was put in place and the changes driven by the Accord, such as the growth of securitization. Over the past few years (as we all know), they have been busily working on new rules to align regulatory capital requirements more closely with underlying risks and to improve risk measurement and management in order to ensure financial stability. There have been delays and false dawns. The new Accord is, however, expected to replace the old Accord from January 1, 2007.

David Manning is head of economic affairs at the European Mortgage Federation (www.hypo.org). Based in Brussels, the Federation brings together private and public mortgage lenders, including universal/commercial banks, mortgage banks, savings banks, mutual and cooperative banks, building societies, umbrella companies and insurance companies. Together they grant around 70% of residential and non-residential mortgage loans in Europe. This article summarizes the views of mortgage lenders in Europe with respect to the current proposals from the Basel Committee on Banking Supervision on bank capital adequacy, which will be transposed into binding legislation in the European Union.

Internal Rating-Based Approach

The big innovation in the new Accord is the possibility for credit institutions to adjust their own funds to the actual risks through the use of the so-called new internal rating-based approach. Under the approach, credit institutions must build models based on loss data with respect to their loan portfolios over a sufficiently long time period. The models of the individual credit institutions must then be approved by national supervisory authorities and must be used in practice by the institutions.

The total volume of outstanding mortgage loans in the E.U. mentioned above gives some indication of the reduction in capital requirements (capital release) that could be achieved by those mortgage lenders that opt for internal rating. The total volume of outstanding residential mortgage loans is currently 3.4 trillion euros. If current capital requirements (i.e., 50% or 4%) could be halved for residential lending, for instance, this would represent an estimated potential saving of some 68 billion euros—very much a ball park figure—for European mortgage lenders.

Revised Standardized Approach—Residential Mortgage Lending

Mortgage lenders welcomed confirmation in the press release dated July 10, 2002 of the Basel Committee's decision to lower the weighting on residential mortgage loans from the current 50% to 40%. They believe that this is concrete recognition of the low level of losses on such lending, which is typically backed by risk reducing mortgage collateral.[2]

Mortgage lenders remain to be fully convinced on the merits of switching from the standardized approach to the internal rating-based approach. They are in the process of analyzing the cost of moving to internal rating against the potential benefits of such a move and note the Committee's reaffirmation (in the above press release) of the importance of the revised standardized approach that will be used by the majority of banks worldwide. Indeed, a number of lenders are concerned that they will be severely disadvantaged by the risk weighting for residential mortgage loans in the revised standardized approach when compared to the possible reductions in capital requirements under internal rating.

Mortgage lending is a safe and well managed business with qualified staff and tried and tested systems. It is important, therefore, that there will be low risk weights for residential mortgage loans in the standardized approach and throughout the Accord. One of the surely unintended consequences of the new Accord could be that such lending becomes less attractive and more expensive, given the differential between risk weights in the two approaches. With respect to the proposed additional operational risk charge, mortgage lenders note the difficulties that exist both in defining the concept of operational risk and reliably determining a charge for such risk.

Internal Rating Models

Two factors have encouraged a significant number of mortgage lenders to start developing internal rating models either individually or as part of an industry-wide effort in their country. Firstly, mortgage lending is a low-risk business and, secondly, lenders have noted the potential for capital release mentioned above. Mortgage lenders in Belgium, Denmark, Germany, Spain, the Netherlands, Sweden and the U.K. are in the process of building data for internal rating models.

One of the principal benefits of national pooling of loss given default figures is to facilitate supervisory approval of internal rating models. It is also considered (especially for small, specialized lenders) to be more cost effective and efficient than engaging in data collection and analysis on an institution-by-institution basis. However, data pooling, to enable a move to internal rating, may not be a practical proposition for lenders in some countries.

Mortgage lenders did consider pooling loss given default data at European level but decided that this was neither feasible nor of added value. European mortgage markets retain strong national characteristics. There are considerable differences across countries due to differences in the types of lenders and, consequently, different features in the types of products on offer, such as the maturity of mortgage loans, the type of mortgage interest rate and loan-to-value ratios. These differences are mostly the result of differences in the political/historical environments and in the legal/regulatory frameworks in which mortgage lenders operate.

Revised Proposals on Internal Rating

The box on page 15 summarizes the revised proposals from the Basel Committee on internal rating, which propose higher risk weights for mortgage lending on the basis of asset correlation.

Mortgage lenders have questioned the Committee's proposal to apply higher risk weights for mortgage lending compared to other retail lending on the following grounds:

- A default on a mortgage loan will not automatically trigger default in other similar loans.
- Capital allocation to cover credit risk is reviewed by lenders on a sufficiently regular basis.
- Since mortgage loans are backed by collateral they should have lower risk weights compared to other retail loans without collateral. (European data show low loss levels on mortgage lending and prove that a loan secured by a mortgage on a property has lower credit risk than a loan without collateral. See box on page 15 for losses on residential mortgage loans.)
- The long-term and on-balance sheet characteristics of mortgage lending in Europe promote stability and discourage volatility in national real estate markets.
- Homeowners try, above all, to avoid repossession of their homes.

SUMMARY OF REVISED PROPOSALS ON INTERNAL RATING

Under the Basel Committee's proposals on internal rating in November 2001 and January 2002, European mortgage lenders consider that mortgage lending is disadvantaged vis-à-vis other retail lending. Based on the results of early quantitative impact studies the Committee concludes that, on average, estimated asset correlations associated with mortgage products are significantly higher than those of other retail products, and are greater than the 8% figure assumed in the January 2001 consultative paper.

The evidence on asset correlations and the longer than average maturities of exposures secured by residential properties suggest different risk profiles for residential mortgage and non-mortgage retail lending. Basel proposes to take maturity – and other risk factors – into account indirectly in the choice of asset correlation. The November 2001 modifications to risk weights are based on an assumed fixed-asset correlation value of 15%. This compares with asset correlation values ranging from 4% to 15% for other retail exposures.

At present, the Committee envisions potentially higher risk weights for residential mortgage lending compared to unsecured retail lending via an additional charge for longer maturities through the assumption of the higher asset correlation figure. Mortgage lenders understand that asset correlation measures the extent to which the returns on two assets move together (i.e., the extent to which those returns behave similarly in response to market events or stimuli).

Mortgage lenders challenge both the supervisory assumption that mortgage lending is riskier than other lending and the risk weights proposed for residential mortgage lending as a consequence. Apparently, the factors contributing to this relatively greater riskiness include the longer maturities of mortgage loans and their lack of contractual flexibility (in the event of a problem loan, their terms and conditions cannot be changed as easily as other lending such as credit card lending). Another factor, according to Basel, is the thin margins on mortgage lending relative to other types of lending. In addition, there will be a capital charge for expected losses for mortgage lending with no set-off for future margin income.

Source: Models Task Force Note on the IRB Treatment of Retail Exposures, January 4, 2002. Basel Committee's Summary of Quantitative Impact Study No. 2 results and potential modifications to the new Basel Capital Accord, November 5, 2001.

Mortgage lenders look forward to the results of the Basel Committee's Quantitative Impact Study No. 3—due at end of 2002—which will examine the impact of the latest proposals (due to be released the second quarter of 2003). (See later section on Quantitative Impact Study.)

Maturity

The typical maturity of a mortgage loan can vary between ten years in some southern European countries to as much as 30 years in Denmark. Mortgage lenders feel that supervisors should not discriminate against mortgage loans because they are long-term. The general rule for own funds allocation to credit risk is that capital has to be allocated only for the forthcoming year, this allocation being reviewed every year for the next 12 months. In the case of impairment of credit quality, own funds will be increased. An additional charge for longer maturities is contradictory to that rule.

The low margins on residential mortgage lending are the result of its low risk and low cost per unit profile. This profile typifies highly standardized residential mortgages and should be recognized in assessing asset correlation. A default of one type of mortgage loan will not automatically trigger default in other similar loans. Generally, real estate markets are regionally diversified and are affected by property and economic cycles in different ways. In general, banks have well diversified mortgage portfolios. Thus, cyclical volatility can be absorbed on a national, or even on an international, level.

The Basel Committee's press release on July 10 indicated that the Committee had reached agreement on the question of adjustments related to the remaining maturity of loans. Mortgage lenders note that there is provision for national supervisors to exempt lending to smaller domestic firms from the maturity framework. They are currently considering how the proposed treatment of maturity would impact them, given the different mortgage funding and lending models in Europe.

Quantitative Impact Study

Quantitative Impact Study No. 3 will be formally launched on October 1, 2002 with a response deadline of December 20, 2002. The European Mortgage Federation has urged its members to participate in the study. Participation in the study will more than likely be interpreted by supervisors as an intention by mortgage lenders to move towards internal rating. The Committee has

> **LOSSES ON RESIDENTIAL MORTGAGE LENDING**
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> Loss data on mortgage lending is limited in Europe. As part of it response to the Basel Committee's January 2001 consultative document, the European Mortgage Federation submitted the following figures which show the historically low loss levels on residential mortgage lending. The complete figures are contained in the Federation's response to Basel, accessible at www.hypo.org.
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> From 1975 to 1999, the losses on mortgage loans were on average 0.22% compared to an average of 1.15% for losses on all lending by the Danish commercial and savings banks. For the period 1990 to 1999, the 0.22% average for all mortgage loans compares to about 0.1% for residential loans. In the period 1994 to 1998, losses of the mortgage banks in Denmark on lending for commercial property averaged 0.254% compared with losses on all lending by the commercial and savings banks which averaged 0.7%.
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> Residential mortgage lending in Germany from 1988 to 1998 had average loss rates of only 0.03% for loan-to-value (LTVs) ratios of less than 60%; 0.15% for LTVs greater than 60%; and 0.05% for LTVs from 0 to 100%. The average loss rates, under the same parameters, for commercial mortgage lending were 0.05%, 0.18% and 0.08%, respectively. For consumer lending over the ten-year period the average loss was 0.26%.
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> In the United Kingdom, for the period 1989 to 1998, the estimated figures for provisions for bad and doubtful debts charged by U.K. building societies in their income and expenditure accounts each year, as a percentage of loans outstanding, ranged from 0.08% (1989) to 0.95% (1992). For a major French mortgage credit provider, losses on residential lending from 1993 to 2000 inclusive ranged from 0% to 0.136% and averaged 0.024% over that period. In Sweden, the relation between losses and the book value of residential mortgages is below 0.1% per year. In Norway, unsecured loans to private retail customers are estimated to have an expected loss given default that is four to seven times as high as an average residential loan.
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> The 1995 Royal Institute of Chartered Surveyors' survey on capital losses on mortgage lending on both residential and commercial property and other lending noted very low capital losses on residential mortgage lending in Germany, Belgium, Italy, the Netherlands, Portugal and Austria. The survey concluded that "in all cases the losses on loans not secured by mortgages are bigger as a percentage of outstanding loans

indicated that, on the basis of the results, it is prepared to make both upward and downward adjustments to the amount of required capital prior to the release for comment of the third consultative paper. Mortgage lenders hope that the results will reflect the low level of losses on mortgage lending.

Commercial Mortgage Lending

At the end of 2001, the volume of outstanding non-residential mortgage lending (offices, retail outlets, industrial premises and, in certain countries, agricultural property) was approximately 500 billion euros, or 13% of the total volume of mortgage loans outstanding in Europe—this percentage has been steadily increasing since 1990.

Under the revised standardized approach, where a commercial real estate loan does not exceed the lower of 50% of the market value (MV) or 60% of the mortgage lending value (MLV), it is proposed[3] that the loan would receive a 50% risk weight subject to the following Basel Committee key criteria:

- Evidence that losses stemming from commercial real estate lending up to the lower of 50% of the MV or 60% of the LTV based on MLV may not exceed 0.3% of the outstanding loans in any given year.
- Evidence that overall losses stemming from commercial real estate lending may not exceed 0.5% of the outstanding loans in any given year.

The Committee requires that the remaining exposure should be subject to a 100% weighting. If either of the above criteria is not satisfied in a given year, the eligibility to use this treatment will cease and the original eligibility criteria would need to be satisfied again before it can be applied in the future.

According to current E.U. rules,[4] supervisors may allow their credit institutions to weight their commercial mortgage loans at 50%. This optional 50% weighting runs until 2006 and the European Mortgage Federation supports its extension and its availability for all mortgage lenders on the basis of the low level of losses on commercial mortgage lending, the presence of mortgage collateral, and the use of prudent loan-to-value ratios. Furthermore, rather than reinvent the wheel, the Federation has urged Basel to apply the current E.U. criteria on this weighting (loan-to-value lending limits and revaluation) and the E.U. definitions of market value and mortgage lending value.

Under the foundation internal rating-based approach, mortgage lenders believe there should be lower loss given default (LGD) figures and greater recognition by Basel of loan-to-value ratios as a parameter in risk measurement and management. Low loan-to-value loans should have lower LGDs.

Mortgage Funding

Europe's mortgage lenders use a variety of funding instruments to fund their mortgage loans, including retail deposits, mortgage bonds and mortgage-backed securities.[5] Mortgage bonds[6] are covered bonds and are the second most important funding instrument for mortgage lenders in Europe, after retail deposits. Mortgage bonds are the single biggest component of privately issued instruments, with approximately 18% of the European capital market. Currently, they fund approximately 15.24% of mortgage loans in the E.U. At the end of 2000, the volume of mortgage bonds outstanding in the E.U. was approximately 616 billion euros.

Under Basel II, there are currently two options in dealing with bank bonds: either based on the risk weight of the sovereign or based on external rating. Under the current E.U. rules, a bank that invests in mortgage bonds applies a 10% weighting to the bond. Currently, ten E.U. member states have legislation in place permitting this 10% weighting. Mortgage lenders believe that there are a number of reasons, outlined below, in favor of maintaining the current 10% weighting in the revised standardized approach.

Firstly, covered bonds are default free. In over 200 years, there have been no defaults of mortgage bonds.[7]

Secondly, covered bonds deserve better treatment than uncovered bonds because of their security—their risk profile is superior to, and they differ markedly from, uncovered bonds. This has been recognized in E.U. legislation[8] including article 22(4) of the UCITS Directive, which details the criteria mortgage bonds must meet to guarantee the safety of the investor. These criteria are:

- The bonds must have been issued on the basis of legal provisions to protect investors.
- Bond issues are subject to special supervisory scrutiny and the issuers are subject to own fund requirements for mortgage loan portfolios.
- The assets covering the bonds are subject to specific rules such as the matching principle, i.e., assets must be in place to cover liabilities over the lifetime of the bonds.
- In the event of bankruptcy of the issuer, the sums deriving from the issue of the bonds are intended as a priority to repay the capital and interest becoming due.
- Member states must notify the bonds, which comply with Article 22 (4) to the Commission.

Thirdly, mortgage bonds fund very secure assets, which are already covered by own funds requirements. Assets underlying mortgage bonds remain on the issuer's balance sheet and are also subject to own funds requirements (i.e., 20% to 100% under the proposed rules) depending on the type of asset.

Under the internal ratings-based approach, mortgage lenders consider that the weightings of mortgage bonds should be based on the intrinsic quality of the bonds and their underlying assets (which exhibit a low level of losses). The security features and the absence of defaults with respect to the bonds are factors that should be borne in mind by regulators and supervisors.

Level Playing Field

In the United States, a large portion of mortgage loans are held off-balance sheet and funded through securitization. Securitization remains relatively costly and capital intensive in Europe. Given the relatively expensive structure of MBS issues in Europe, mortgage bonds[9] continue to be very popular and are the second most important funding instrument in Europe after retail deposits. In addition, there are no centralized issuing institutions, similar to the U.S. GSEs that would de facto impose a standardization of contracts and practices to allow selling mortgage loans to capital market investors.[10]

Europe's mortgage lenders are concerned about:

- The GSEs' implicit government guarantee that allows them to access cheaper funding on the U.S. and European capital markets, and
- The very favorable prudential treatment of the agencies with respect to capital adequacy requirements compared to European credit institutions.

These concerns have been raised with the European Commission and the relevant correspondence can be assessed on the European Mortgage Federation's web site (www.hypo.org).

Tables 1 and 2 outline the important role U.S. GSEs play in the housing market and the prudential treatment of mortgage lending and funding in the U.S. and Europe.

The Accord Timetable

The recent Basel Committee's press release confirms the revised timetable for finalizing the new Accord. On July 10, 2002, the European Commission issued a press release outlining its plans. Readers will recall that

Table 1. Public Guarantee: The Important Role of the U.S. Government-Sponsored Enterprises

United States	*Europe*
• The U.S. central government-sponsored enterprises (Fannie Mae and Freddie Mac) play a central role. They buy mortgage loans from mortgage banks and sell them into the secondary mortgage market.	• There is no national or European government agency to help lenders fund their loans. Mortgage loans have to be funded on the basis of the financial strength of banks or the intrinsic quality of the securities.
• These enterprises enjoy the implicit backing of the U.S. government, which reduces funding costs by about 50 basis points.	• E.U. law (Article 87 and 88 of the EC treaty) outlaws state aid in the form of guarantees, as there may be an element of competitive distortion.
• The sheer size of the enterprises allows economies of scale. Fifty percent of all outstanding residential mortgages at the end of 1997 were securitized. This amounted to about $2 trillion, out of a total market of $4.1 trillion.	• There are privately-owned, centralized issuing institutions; but their existence is threatened because of differing ratings of originating institutions. Private centralized issuing institutions have difficulties in creating liquidity.
Consequences:	*Consequences:*
• There is an element of state aid in American motgage funding.	• E.U. mortgage lenders enjoy no funding advantage through government backing.
• Fannie Mae, Freddie Mac and the Federal Home Loan Bank debt (not MBS) trade at 20-50 basis points over government bonds, on an option-adjusted basis; MBS trade at 70 to 100 basis points over comparable duration government bonds.	• Mortgage bonds trade 40 to 50 basis points over government bonds.
	• E.U. mortgage-backed securities currently trade with an average margin of 75 to 150 basis points over government bonds.

Table 2. Prudential Treatment of Mortgage Loans and Funding Instruments

United States	*Europe*
Mortgage Lending	*Mortgage Lending*
• Not on balance sheet.*	• On balance sheet : 50% or 100% weighting.
Funding	*Funding*
• MBS issued by U.S. government-sponsored enterprises: 20% weighting.	• MBS: 50% weighting (directive 98/32/EC).
• MBS issued by other institutions: 20% (if AAA-rated) (regulations currently under review).	• Mortgage bonds: 10% weighting (directive 89/647/ EEC) and 50% weighting of mortgage loan.
Consequences:	*Consequences:*
• Funding instruments are inexpensive.	• Funding instruments are relatively costly and capital intensive.

* Loans originated and held by banks and savings and loans have a 50% risk weight. Mortgage banks, which originate a majority of loans, have limited capital needs as they sell their loans, primarily to government-sponsored enterprises. Loans held by those enterprises (Fannie Mae and Freddie Mac) have a minimum capital requirement of 2.5% (a 31.25% risk weight). In addition, loans with LTV of 80% or more have mortgage insurance coverage (roughly 5% of the portion over 80%). Loans sold by the GSEs as MBS have a capital requirement of 0.45% (5.625% risk weight). A majority of loans sold as MBS are in fact held by banks and savings and loans with a risk weight of 20%. Only GNMA-insured securities have 0% risk weight.

the new Basel Capital Accord was originally supposed to be in place by 2004.

The new Accord will run in parallel with the old 1988 Accord for one year from January 1, 2006 and will replace the old Accord from January 1, 2007. The European Commission hopes to have legislation in place in the E.U. member states at the same time as the new Accord so as not to disadvantage the European financial services industry. The timeliness/punctuality of E.U. legislation is, in fact, a level playing field issue and mortgage lenders in Europe hope that the E.U. can meet the deadline.

Towards the end of last year, the Basel Committee realized that agreement was still needed on the remaining outstanding issues (small- and medium-sized enterprises (SMEs)) and related bank lending, retail lending, maturity, calibration, specialized lending, asset securitization, operational risk and "pro-cyclicality"). The Committee also recognized that the third consultation paper (CP 3) scheduled for the second quarter of 2003 from Basel should "get it right" and that QIS 3 should be completed before CP 3 in order to fine-tune (increase or decrease capital requirements for the different types of lending) in its proposals.

The Federation has outlined below a tentative timetable (Table 3) with respect to Basel and Brussels on the new Accord. Having European legislation on capital adequacy in place by (say at the earliest) September 2005, to allow time for its transposition into legislation in the 15 E.U. member states is an ambitious target for the institutional players—the Commission, the Parliament and the Council—for a number of reasons including:

- The likely complexity of the draft legislation.
- The complex arrangements needed to agree, implement, enforce and review the legislation (e.g., the use comitology and possible inter-institutional power plays between the Commission and the Parliament).
- The scheduling of European Parliament elections for the middle of 2004.[11]
- Possible concerns on the part of industry and member states with the impact of certain aspects of the directive.

Finally the box on page 20—Legislating for Basel in the European Union—indicates that incorporating the new Basel Capital Accord into E.U. legislation will be a challenge for the European Union. Indeed, the complexity inherent in the whole Basel process has contributed to the ongoing review by the Commission of the somewhat cumbersome

Table 3. Indicative Basel/Brussels Timetable on the New Basel Capital Accord

Basel Action	*Brussels Action*	*Timeline*
• Release of QIS 3 (plus proposed frame work with quantitative requirements). • Release of overview paper (complexity vs. risk sensitivity, pro-cyclicality).		October 2002
	Working document for Commission pre –consultation structured dialogue.	Late October 2002
Deadline for response to QIS 3.		December 20, 2002
Release of CP 3—Basel.		2nd quarter 2003
	Release of CP 3—Commission.	Early summer 2003
Release of new Basel Capital Accord.		4th quarter 2003
	Commission Proposal for a Directive amending existing capital adequacy directive (1993/6/EEC).	Early 2004
	Adoption of Commission Directive.	3rd/4th quarter 2005
Parallel running of the new and old Accord.	Parallel running of the new and old Accord.	All of 2006
Implementation of the new Accord.		End 2006/Early 2007

LEGISLATING FOR BASEL IN THE EUROPEAN UNION

The European Commission participates in the Basel Committee and its working groups as an observer. Nine E.U. member states are represented on the Basel Committee.[12] Six member states are therefore reliant on the Commission and the other member states to represent their interests.

This is an unusual situation for the Commission since normally on financial services policy in Europe it sets the agenda by initiating legislation. In this situation, policymakers in Brussels have pointed out that they are supplementing the consultative process launched by Basel with a focus on issues of particular E.U. concern. In addition, the Commission has pointed out that what distinguishes the capital regime in the E.U. from the Basel process is that it is a legislative framework and that it applies both to the banking industry and to investment firms irrespective of their size.

way in which Europe's financial services are currently regulated. The review and its possible outcomes are perhaps the subject of another article in another place and at another time.

NOTES

1 Government-sponsored enterprises, or American federal agencies, comprise Fannie Mae (the Federal National Mortgage Association), Freddie Mac (the Federal Home Loan Mortgage Corporation) and Ginnie Mae (the U.S. Government National Mortgage Association).

2 The European Mortgage Federation has carried out a comprehensive study on the efficiency of mortgage collateral in the European Union. The study looks at both residential and commercial mortgage loans. It covers all areas that determine the efficiency of the mortgage collateral including constitution and registration, the ranking of the surety as well as repossession (i.e., forced sale procedure). The study shows that very often the principles underlying the differing national legislations are the same or similar with differences rising in the actual application, i.e., timing, level of costs, competent authority, etc. All of the national systems appear to be secure and efficient on a general basis. There is, however, room for improvement.

3 Proposal for treatment of commercial real estate lending, BS/00/90, Draft July 5, 2000, Basel Committee on Banking Supervision, Note by the Secretariat.

4 1998 Solvency Ratio Directive.

5 At the end of 1998, the European Mortgage Federation estimated that the total value of residential mortgage lending outstanding in the European Union was funded as follows: retail deposits (62%), mortgage bonds (19%) and mortgage-backed securities (1%). The estimate for MBS was relatively low. However, MBS issuance has increased strongly in recent years and securitization has become an attractive funding instrument for mortgage lenders looking for a transfer of risks or the diversification of their funding sources.

6 Bank bonds include both covered and uncovered bonds. Mortgage bonds are essentially debt securities issued by (mortgage) credit institutions and covered by certain types of assets, usually mortgage loans, which remain on the balance sheet of the issuer. Covered bonds can be secured against mortgage assets or claims against public sector entities. Source: *Mortgage Banks and the Mortgage Bond in Europe*, European Mortgage Federation, 3rd edition, 2001.

7 In Germany, in 1924 and 1948, mortgage bond holders were expropriated by currency reforms although the real collateral underlying the bonds held its value (even after World War II). In both cases, the resulting capital gains for the borrowers were taxed away by the government through a debt revaluation tax.

8 Mortgage bonds are referred to in a number of directives, such as:

- the solvency ratio directive (mortgage bonds are granted a 10% weighting),
- the large exposures directive (mortgage bonds are excluded from the limitations for large exposures),
- the deposit guarantee schemes directive (mortgage bonds already offer sufficient guarantees and are, therefore, excluded from the directive),
- the third non-life insurance and the third life assurance directive (which allow insurance undertakings to invest up to 40% in mortgage bonds).

9 Sometimes also called covered bonds, i.e., on-balance sheet instruments.

10 Articles 87 and 88 of the consolidated version of the Treaty on European Union outlaw state aid in the form of guarantees, as there may be an element of unfair competition. Therefore, although some E.U. member states have centralized issuing institutions, which pool mortgages from a number of lenders and that are owned by private shareholders, E.U. member states are not allowed to create national agencies similar to the U.S. government-sponsored enterprises.

[11] European Parliament elections are held every five years. In the 1999 elections, approximately half of those elected were elected as Members of the European Parliament for the first time. If there would be a similar change of personnel in 2004, it could slow down progress on what promises to be technically complex and time consuming legislation. In addition, the business of the Parliament, i.e., legislating will be on hold during the election period.

[12] Belgium, France, Germany, Italy, Luxembourg, the Netherlands, Spain, Sweden and the United Kingdom.

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