Property value in CRR3

Notable impact on some mortgage covered bonds

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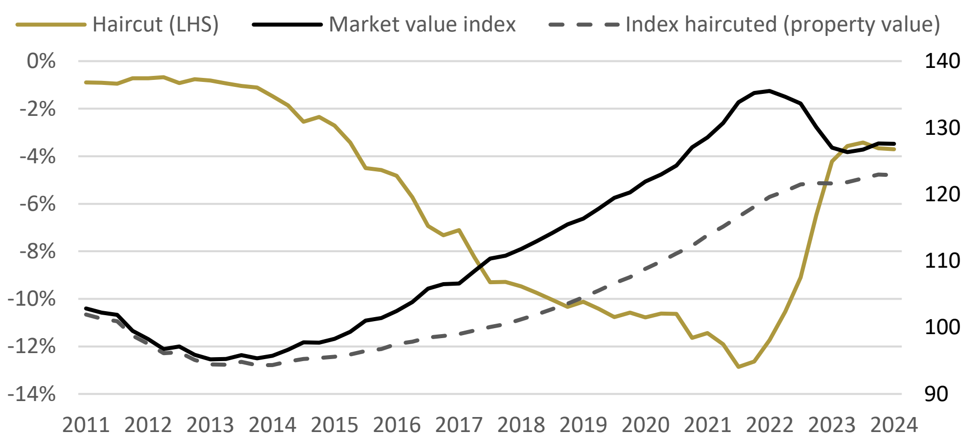
There is less than six months to go until the 'property value' in the updated Capital Requirements Regulation (CRR3) must be operationalised in all 27 EU member states (by 1 January 2025). Even though this is just one of many updates to the banking package and the final elements for the implementation of Basel III in the EU, it could have a notable impact on covered bonds because market values are directly linked to the maximum amount of covered bonds that can be issued.

Updated article 229(1) of the CRR matters because it will determine the valuation standards to be used for covered bonds backed by mortgages (129(3) CRR). Covered bonds will not be allowed to use the current market value of a property. The value must be one that "excludes expectations on price increases" and must be "sustainable over the life of the loan". As such the property value cannot exceed either the current market value or the average market value over the last six years for residential and eight years for commercial property.

To gauge the effects of the updated property value definitions, we calculated the haircut on residential property values assuming the directive had been transposed and that no country exceptions or transitions were granted. We then factored in European house-price indices since 2005 and calculated the floating average over six years to compare it to the respective index value.

Our analysis demonstrates that the Commission's proposal to reduce the impact of cyclical effects on the valuation of property securing loans and to keep capital requirements for mortgages more stable works relatively well.

Figure 1: Haircut to market value (residential)



Source: Eurostat, Scope Ratings

It comes as no surprise that the discount negatively correlates to property-price increases over the same period. Neither is it a surprise that the discount peaked in 2022 following a period of double-digit growth for residential property. The discounts have obviously decreased since then, reflecting the price corrections observed in many European countries.

The definitions in the CRR do leave some room for interpretation, however. Our analysis was based on real house prices rather than nominal values. If we were to consider nominal house prices i.e. not adjusting for inflation, today's haircut would be 14%, versus 4% considering nominal values.

Market value will not become redundant, as it will remain a key determinant of the property value, but it does set a cap on the calculation basis under the CRR and potentially also for the loan-to-value criteria of covered bonds.

Also, national regulatory bodies may allow institutions to use market value or mortgage lending value without limiting increases in property value as stated above. Silence will not mean the status quo has been maintained, though, as the directive will enter into force from 2025. But a transition period may be possible for exposures created before January 2025 (until next revaluation) and to those member states already applying a 'rigorous' lending value concept. This transition may be applicable until December 2027.

Diversified value haircuts to European countries

At country level, Europe is once again showing how diverse it is and here there is something of a vertical split. For most central European countries, no haircut would have to be applied to market values as of Q1 2024. But Southwestern and Eastern European countries show a haircut of up to 12%. This reflects market values well above the medium-term average. This is where LTVs may go up quite substantially having an effect on asset eligibility and finally on over-collateralisation.

Figure 2: Implied haircuts in Europe (Q1 24)

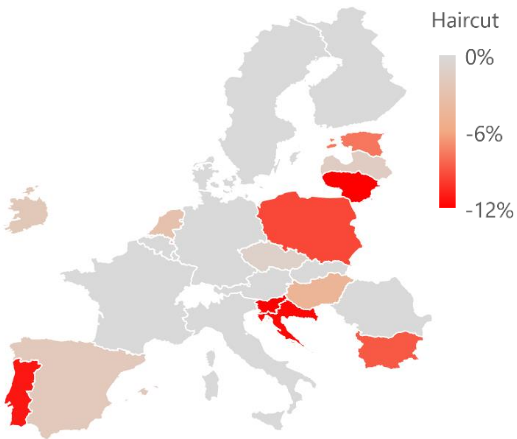
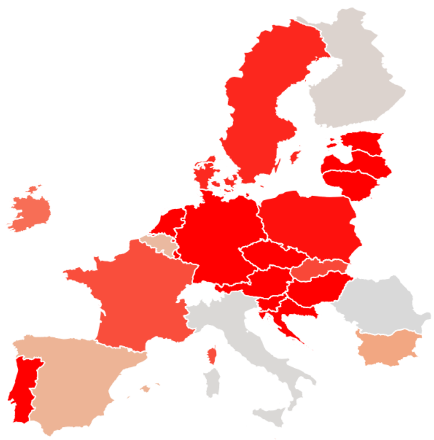


Figure 3: Implied haircuts in Europe (Q1 22)



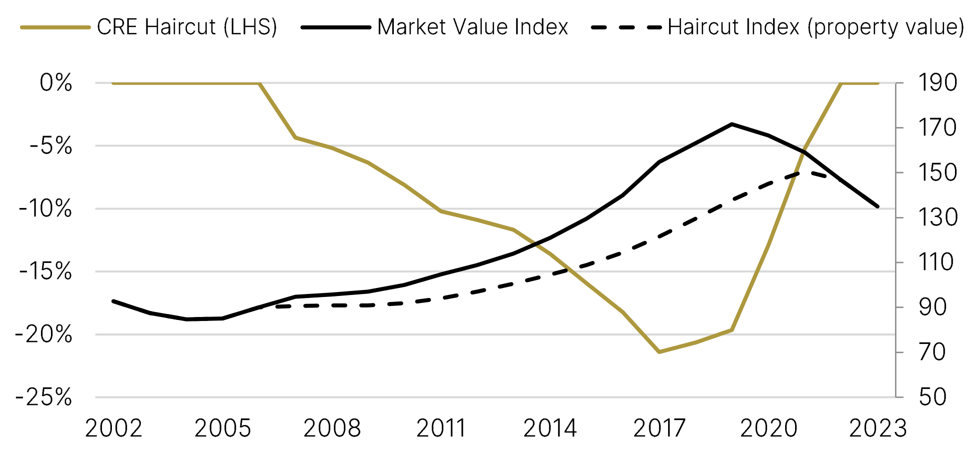
Source: Eurostat, Scope Ratings

However, despite a potential transition period to implement the property value or potential exceptions, not all of the above countries will have to significantly adjust their value downwards from 2025. Hence, we do not expect to see rising LTVs in mortgage covered bonds across the board. This is also because in some countries the value basis for determining issuance volumes of covered bonds already follows a prudent or sustainable approach. Austria, Germany, France and Spain, for example, take into account prudent or long-term considerations when assessing the values relevant for collateralising covered bonds.

Bespoke haircuts to commercial real estate

Applying the 'property value' for large-scale commercial real estate will typically not be based on market indices but from individually updated valuations. However, to visualise its impact, we illustrated the haircut based on German CRE indices.

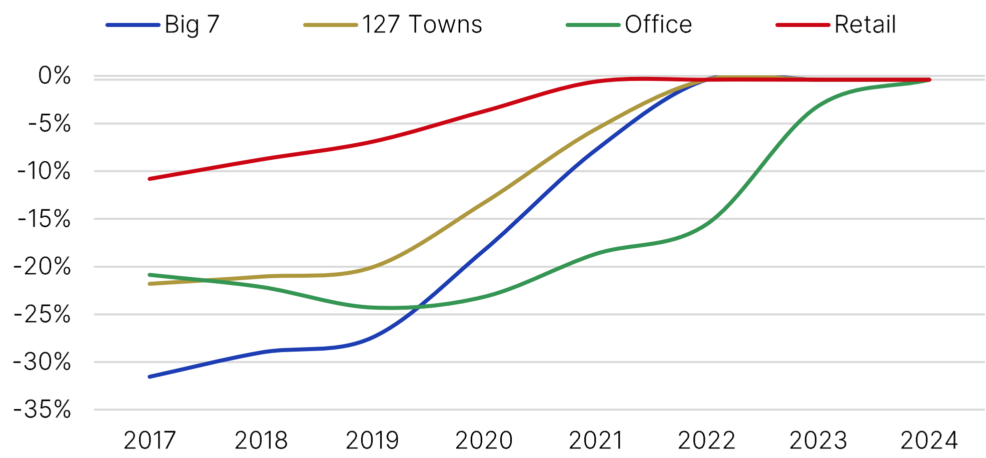
Figure 4: Haircut to market value (German commercial property)



Source: Eurostat, Scope Ratings

Generally, the haircut flattens the nominal price index we used for the commercial illustration. Hence it shows lower volatility but also an imminent conversion to lower (capped) current market values. We can also show differences within certain regional or property-type clusters. Prime properties in the largest cities in Germany (the Big 7) tend to show higher haircuts than the more diversified sample of 127 German cities and towns. The latter also did not benefit from super-low yields of around or even below 3% during the period of ultra-low interest rates. Hence a parallel shift reflecting the higher interest-rate environment had fewer effects on updated valuations.

Figure 5: Haircut by type and region (German commercial property)



Source: Deutsche Bundesbank, Scope Ratings

Since 2017 retail properties have had a materially lower haircut compared to office properties as retail properties already went through phases of strong value corrections driven by e-commerce penetration and the pandemic. Consequently, retail has not observed the same growth rates as some other property types. What all segments have in common, however, is that today no haircut would have been applicable to their market values as the current market value is lower than their eight-year average. It should be noted, though, that CRE is a highly bespoke asset class where an index does not reflect the individual path and implicit haircuts accordingly.

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