Mortgage Info 01/07

COMMERCIAL MORTGAGE LENDING AND MORTGAGE CREDIT FOR SMALL AND MEDIUM SIZED ENTERPRISES

This *Mortgage Info* concerns the impact of the current capital adequacy proposals on commercial mortgage lending and mortgage lending for small and medium sized enterprises (SMEs). It completes *Mortgage Info 6* on residential mortgage lending.

Commercial mortgage lending

The Basel proposals recognise the importance of mortgage credit to SMEs, in particular:

- commercial mortgage lending may, in exceptional circumstances, be weighted at 50%;
- the central role of mortgage collateral as security for funding of SMEs is addressed under the internal rating based approach (IRBA) for corporate exposures.

Revised standardised approach

With regard to the weighting of commercial mortgage property loans, the Commission proposes to maintain the 50% weighting that exists in EU legislation[1] until the end of the transition period in 2006. It does however not exclude that this could be changed to bring the treatment more in line with the Basel Committee's proposals which, in addition to limiting the 50% weighting to certain LTV ratios, impose additional disclosure requirements for data on losses.

Calibration of risk weights for corporate exposures

Under the IRBA, banking book exposures have been categorised into a number of asset classes; one of which is corporate exposures. The Committee has provided tentative risk weights for corporate exposures for given PDs. These are outlined in the table below.

Table 1: Calibration of Risk Weight for Corporate Exposures in the Internal Rating Based Approach

PD (%)	BRW[2] Corporate
0.03	14
0.05	19
0.1	29
0.2	45
0.4	70
0.5	81
0.7	100
1	125
2	192
3	246
5	331
10	482
15	588
20	625
30	N/A

Source: The New Capital Accord, January 2001

The Committee gives as an example the risk weights based on a calibration that would produce a capital requirement of 8% (100%) for an asset with a 0.7% probability of default (PD), 50% loss given default (LGD) and a three-year maturity.

Recognition of collateral

Banks under the foundation IRBA may obtain capital relief from physical collateral such as

[1] Directive 2000/12/EC Article 62 (1) and (2) replacing Article 11 (4) and (5) of the Solvency Ratio Directive

2 BRW – Benchmark Risk Weight

commercial real estate (CRE) and residential real estate (RRE).

CRE as collateral for corporate loans is defined as:

- collateral where the risk of the borrower defaulting is not materially dependent upon the performance of the underlying property or project, but rather on the underlying capacity of the borrower to repay the debt from other sources.
- additionally, the value of the collateral pledged should not be materially dependent on the performance of the borrower.

Construction lending, raw land, project lending and income producing/investment CRE are specifically excluded from collateral types for this purpose.

Corporate exposures to small and medium sized enterprises may be secured by the residential real estate of the directors or owners. Lending to housing developments or apartment blocks where the risk of repayment of the loan is significantly dependent on the cash flow generated through rental streams is not intended to be covered by this definition.[3]

Operational requirements

CRE and RRE will be eligible for recognition as collateral for corporate claims only if all of the operational requirements summarised below are met.

- Legal Enforceability: any collateral taken must be legally enforceable under all applicable laws and statutes, and claims on collateral must be properly filed on a timely basis.
- Objective Market Value of Collateral: the collateral must be valued at or less than the current fair value under which the property could be sold under private contract between a willing seller and an arm's-length buyer on the date of valuation.
- Frequent Revaluation: the bank is expected to monitor the value of the collateral on a frequent basis and at a minimum once every year. More frequent monitoring is suggested where the market is subject to significant changes in conditions.
- First Claim: the bank should have a first lien on, or charge over, the collateral. As such, it should have priority over all other lenders to the realised proceeds of the collateral. No recognition for second or subsequent charges will be provided, and these will be treated as senior unsecured exposures.

Additional collateral management requirements include the following:

- The types of CRE and RRE collateral accepted by the bank and policies and practices in respect of the appropriate amount of each type of collateral relative to the exposure amount should be clearly documented in internal credit policies and procedures.
- Bank credit policies should address appropriate collateral requirements relative to the exposure amount, the ability to liquidate the collateral readily, the ability to establish objectively a price or market value, the frequency with which the value can readily be obtained (including a professional appraisal or valuation), and the volatility of the value of the collateral.

[3] It is noteworthy in the Accord that there is inconsistency in the definitions of commercial real estate between the revised standardised approach and the foundation IRBA. One of the main criteria permitting the 50% weighting for commercial mortgage lending in the revised standardised approach is that the property has rental income with which to service the loan. In IRBA this type of lending is excluded and therefore there is no incentive for lenders to move from the revised standardised to the IRBA.

- Collateral management should be contained within a distinct operational unit of the bank.

Determination of loss given default

The new Accord outlines a methodology for determining the effective LGD under the foundation approach for cases where banks have taken CRE or RRE collateral to secure a corporate exposure. The methodology is summarised below:

Exposures where the minimum eligibility requirements are met, but the ratio of current collateral value (C) to the nominal exposure (E) is below a threshold level of 30% would receive the appropriate LGD for unsecured exposures or those secured by non-recognised collateral of 50%. Exposures where the ratio of collateral value to the nominal exposure exceeds a second, higher threshold level of 140% would be assigned an LGD of 40%. Exposures where the ratio of the collateral value to the nominal exposure is between the threshold levels as defined in the previous paragraphs would receive an effective LGD that is a weighted average of the secured and unsecured LGD figures as specified below. These three cases are summarised in the following table:

Table 2: Collateral as a percentage of nominal exposure mapped to LGD

	Condition	Effective LGD
Case 1	C/E ≤30%	50%
Case 2	C/E>140%	40%
Case 3	30%<C/E ≤140%	{1-[0.2 x (C/E)/140%]} x 50%

Source: The New Basle Capital Accord, January 2001

Implementation Issues

The length of the underlying historical observation period used must be at least 5 years and a bank will need to meet this requirement by the conclusion of the transition period (three years after implementation in 2004). A bank must have a minimum of 2 years of data by the time of implementation.

Next steps

The Federation's experts welcome the recognition by supervisors of the importance of mortgage collateral for SMEs and note the stringent eligibility requirements. The Federation's experts are concerned about the different definitions of commercial real estate between the revised standardised approach and the foundation IRBA.

Discussions are currently underway on the Accord at both national and European levels between the mortgage credit sector and their supervisors. The Federation will be responding formally, in due course, to both the Basel Committee and the European Commission.

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