

EBA/Op/2014/02

30 April 2014

Opinion of the European Banking Authority on measures to address macroprudential or systemic risk

Introduction and legal basis

1. On 1 April 2014 the EBA received a notification from the National Bank of Belgium (NBB) of its intention to make use of Article 458 of Regulation (EU) No 575/2013 of the European Parliament and of the Council¹ to modify capital requirements in order to account for an increase in macroprudential or systemic risk that could have a severe impact on the financial system and the Belgian real economy.
2. The EBA competence to deliver an opinion is based on Article 34(1) of Regulation (EU) No 1093/2010 of the European Parliament and of the Council² and Article 458(4) of Regulation (EU) No 575/2013. Article 458 of Regulation (EU) No 575/2013 requires designated authorities to notify the EBA where the authority identifies changes in the intensity of macroprudential or systemic risk in the financial system with the potential to have serious negative consequences to the financial system and the real economy in a specific Member State and which that authority considers would better be addressed by means of stricter national measures. Within one month of receiving the notification the EBA is required to provide its opinion on the points in Article 458(2) of that Regulation to the Council, the Commission and the Member State concerned.
3. In accordance with Article 14(5) of the Rules of procedure of the EBA, the Board of Supervisors has adopted this opinion.

¹ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1)

² Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority) amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12)

Nature of the proposed measure

4. The proposed measure includes an increase of risk weights for retail exposures secured by Belgian residential immovable property for Belgian IRB banks by an add-on of five percentage points and therefore addresses asset bubbles in the residential property sectors as included in Article 458(2) of Regulation (EU) No 575/2013.

General comments

5. Based on the evidence submitted by the NBB, the EBA acknowledges that the increase in house prices and debt levels in combination can pose a threat to financial stability for Belgian banks.
6. At this stage, the EBA does not object to the adoption of these measures, since it will increase the resilience of the Belgian banking sector and the increase of risk weights was already introduced in 2013 without any sign of negative impact on the internal market. EBA acknowledges that an additional capital requirement is justified by the potential overvaluation of the Belgian real estate market. In addition, the Board of Supervisors and relevant supervisory colleges have not identified any concerns with the proposed measure or likely negative consequences.
7. However, the EBA has identified a number of issues to which it would like to draw the Commission's attention:
 - Information provided in the notification and data analysed by the EBA indicate that the level of risk varies from credit institution to credit institution and that risk weights are relatively low due to low LGD values. The dispersion across credit institutions suggests that the issue of low risk weights could be addressed using institution-specific (microprudential) instruments as also mentioned by the NBB. The EBA therefore agrees with the NBB that an evaluation of the adequacy of IRB models applied by credit institutions should be carried out in accordance with Article 101 of Directive 2013/36/EC of the European Parliament and of the Council³, with a focus on downturn LGDs. The EBA also acknowledges that the re-assessment of internal models can take time and might not be sufficient to fully address the macroprudential purpose. In any case, the conclusion of this evaluation should be taken into account when reviewing the measure.
 - The EBA's view is that, given the variance of credit institutions' risk profiles, this could also be addressed with institution-specific supervisory measures in accordance with Articles 103 and 104 of Directive 2013/36/EU. This could also limit potential distortions caused by a constant add-on to risk weights that could penalize banks with more conservative credit standards or models.

³ Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338)

Specific comments

8. A detailed assessment of the notification is included in the Annex.

This opinion will be published on the EBA's website.

Done at London, 30 April 2014

Andrea Enria

Chairperson

For the Board of Supervisors

Annex 1: Assessment of the notification

Background

9. The notification was received in the form of a letter from the Ambassador of the Belgian permanent representation to the European Commission, Dirk Wouters, to the Chairperson of the EBA, Andrea Enria, as well as in the form of an electronic notification in a template specified by the ESRB. In addition, supplementary information provided by the NBB to the EBA and the ESRB was used as a basis for the opinion. In the process of compiling the opinion, EBA staff met with the NBB together with the ESRB to gather background information on the proposed measure. The information required in these meetings was also incorporated in the opinion.
10. In summary, the proposed measure includes an increase of risk weights for retail exposures secured by Belgian residential immovable property for Belgian IRB banks by an add-on of five percentage points. This macroprudential measure is part of a broader set of measures introduced in 2013. It includes as additional microprudential measures, the evaluation of the calibration of PD and LGD models to address potential weaknesses of the risk parameters used in the IRB approach and a self-assessment of credit institutions' credit standards against EBA guidelines.
11. The EBA informed relevant colleges of the notification. No concerns were raised regarding potential negative effects on other countries.
12. The remainder of this document is structured along the points of Article 458(2) of Regulation (EU) No 575/2013. References to the CRR and CRD refer to Regulation (EU) No 575/2013 and Directive 2013/36/EU respectively. In particular, the document will comment on information supplied and reasoning given in the notification regarding the following:
 - the changes in the intensity of macroprudential or systemic risk;
 - the reasons why such changes could pose a threat to financial stability at national level;
 - the justification of why Articles 124 and 164 of the CRR and Articles 101, 103, 104, 105, 133, and 136 of the CRD cannot adequately address the macroprudential or systemic risk identified, taking into account the relative effectiveness of those measures;
 - the draft national measures for domestically authorised institutions, or a subset of those institutions, intended to mitigate the changes in the intensity of risk, and its application concerning points (i) to (vii) of Article 458(2)(d) CRD;
 - why the draft measures are deemed to be suitable, effective and proportionate to address the situation; and

- the assessment of the likely positive or negative impact of the draft measures on the internal market.

13. Whenever the argument is supplemented by quantitative analyses, the information is sourced from EU-wide data as of end 2012 available to the EBA.

Article 458(4)(a) CRR

14. The main argument given in the notification is that while developments in the Belgian property market, i.e. growth in house prices and mortgage credit, and signs of overvaluation of the residential property market, pose a risk to Belgian institutions according to the NBB, risk weights for residential mortgages for Belgian IRB credit institutions seem to be relatively low compared to other countries. In particular, high risk sub-segments (mainly a combination of high LTV and high debt-service ratios) exist that could be the source of credit loss if conditions in the Belgian housing market worsen.

15. Risk weights derived from internal models are calibrated on historical credit loss data in Belgium and there is no experience of major housing shocks in Belgium in recent decades. The NBB argues that relative risk weights reflect well the relative riskiness of credit institutions' portfolios, suggesting that models are able to rank correctly the risks, but these risk weights might not be sufficient to absorb credit losses that could materialize in a severe downturn of the Belgian housing market (for which several indicators signal a potential overvaluation of housing prices relative to fundamentals).

16. Figure 1 shows that risk weights for residential mortgage exposures are indeed at the lower end compared to other Member States. The driver for this seems to be a low average LGD while PD parameters are even above average values for the Union as shown in Figure 2 and Figure 3. Obviously, this evidence is not definitive. Country of location of the exposure can be a driver of risk weight diversity. Exposures located in countries that recently experienced more stressed economic conditions generally obtain higher average risk weights as one would expect. Other country-specific aspects could play a role too, including the legal framework around repossession and liquidation of collateral.

17. Low LGD values can be due to either the calibration of underlying models or inherently lower risk in the credit institutions' portfolios. For an assessment of the adequacy of the proposed measure, relative IRB risk parameters would therefore have to be compared to IRB risk drivers or realised risk measures. If risk weights are low compared to underlying risk drivers or to realised loss parameters, a recalibration of models might be warranted. In practice, this recalibration may take a long time and may be difficult to justify. In particular, the changes in risk intensity should be analysed. Data provided by the NBB shows a fairly stable level of the default rate in the IRB portfolio since 2005, with a slight increase in recent years. The need for additional capital requirements as stated by the NBB therefore does not stem from an observed increase in losses but from the strong increase in house prices over the last years that could at some point turn and cause credit losses.

18. Figure 4 indicates that the increase in house prices has led to a decrease of the average LTV in credit institutions' portfolios. However, this does not necessarily result in a decrease in riskiness since conditions in the Belgian housing market might turn at some point, and result in higher losses if default rates are increasing as well.
19. Figure 5 compares the LGD with realised loss rates⁴. Low values of the LGD seem to reflect low historical losses. Here it should be noted that the analysis is just focussed on one year due to data constraints. However, the result is in line with the statement of the NBB that low risk weights can be due to the available loss experience of Belgian credit institutions.
20. Another question is whether the issue of low risk weights is institution-specific, which seems to be implied by the finding of the NBB regarding high risk sub-segments with varying shares from bank to bank that reflect differences in banks' credit standards at origination.
21. While there is a significant variance in risk weights for residential mortgages among Belgian IRB credit institutions as shown in Figure 6, average LGD values applied seem to be close to the regulatory minimum for most credit institutions as shown in Figure 7. However, this result should be treated with care, as this includes the LGD floor, holds for portfolio averages only and does not take into account the distribution of LGD for each bank. The un-floored average LGD of Belgian credit institutions ranges from 2.9 percent to 13.3 percent. Figure 8 shows the distribution of high LTV buckets over Belgian IRB credit institutions. It can be seen that credit institutions are exposed to high risk segments to a varying degree. An analysis of the debt service ratio as shown in Figure 9 gives a similar picture.

Article 458(4)(b) CRR

22. The NBB infers the importance for financial stability from the size of the residential mortgage loan portfolio, i.e. accounting for around 15% of total assets for Belgian credit institutions (with significant dispersion). The NBB did provide additional information on a stress test carried out, which will be described in later sections of this document, as well as other sources, including the ESRB, the OECD and the IMF that confirm risk stemming from an overvaluation of Belgian housing prices. Therefore the EBA acknowledges a possible threat to financial stability.

Article 458(2)(c) CRR

23. Given the high market share (more than 90%) of the seven IRB institutions as stated by the NBB and also following the argument of relatively low IRB risk weights while STA risk weights are sufficiently conservative, Article 124(2) CRR, i.e. allowing competent authorities to set higher risk weights for exposures secured by mortgages, is not applicable.
24. Regarding the applicability of Article 164(5) CRR, which allows competent authorities to set minimum values higher than 10% for the LGD used for retail exposures secured by residential property, it is argued that this would distort the relative risk weights between institutions that

⁴ Proxy by average recovery rate used by banks on their LGD models for Belgian residential mortgage exposures

is seen as consistent with the relative risk profiles for respective portfolios and that it would not influence banks with less conservative credit standards. This argument is based on the fact that un-floored average LGD of Belgian credit institutions ranges from 2.9 percent to 13.3 percent so that increasing the floor will penalize institutions with the most conservative lending standards.

25. Article 101(1) CRD specifies requirements for competent authorities to review on a regular basis, institutions' compliance with the requirements regarding approaches that require permission by the competent authorities before using such approaches for the calculation of own funds requirements. Where material deficiencies are identified in risk capture by an institution's internal approach, competent authorities shall ensure they are rectified or take appropriate steps to mitigate their consequences, including, by imposing higher multiplication factors, or imposing capital add-ons, or taking other appropriate and effective measures. While it is acknowledged that these requirements relate to bank-specific measures, the regular review of internal approaches can be a tool to address potential weaknesses in IRB models leading to low risk weights as proposed by the NBB as an additional microprudential measure. In particular, although not specifically referenced in Article 458 CRR, it is relevant in this context that following Article 181 CRR, institutions shall use LGD estimates that are appropriate for an economic downturn if those are more conservative than the long-run average. In this regard, the conservatism of LGD estimates is not limited by available historical data. The NBB states that for the time being, there is no indication that the IRB models are not meeting the eligibility criteria of the CRR. The models are themselves subject to regular back testing and recalibration to take into account new information on default and losses. A downturn LGD may not necessarily sufficiently take into account the risk of a bubble in the Belgian real estate market.
26. Article 102 CRD does not apply since the measure proposed by the NBB is not related to a breach of CRR or CRD requirements.
27. Article 104 CRD gives competent authorities, as part of the supervisory review process, the power to require institutions to hold own funds in excess of the requirements set out in the CRR relating to elements of risks and risks not covered in the CRR. In this context, Article 103(1) CRD specifies that the supervisory review and evaluation process can be applied in a similar or identical manner to institutions with similar risk profiles. Concerning the applicability of these two paragraphs, a number of issues should be considered:
- The NBB argues that both paragraphs are not applicable since the proposed measure is not based on the supervisory review process but on concerns regarding the banking sector as a whole and the fact that all the banks will be hit by a downturn on the market. However, the notification is also based on the argument of important sub-segments in the outstanding portfolios of mortgage loans that combine high risk levels of risk parameters such as the LTV and debt service ratio. The shares of these sub-segments vary from institution to institution. An input to the specification of vulnerabilities and the derivation of bank-specific capital requirements could be given by stress tests as defined in Articles 97, 98 and

177 CRD in the context of the supervisory review and evaluation process. Article 103 CRD mentions not only an identical but also a similar application. It therefore seems that this Article also applies to different risk profile in the context of a similar broad risk factor like housing prices. It is also not clear how institution-specific risk profiles can, on the contrary, be better addressed with an identical increase of risk weights across all institutions as proposed.

- It can also be argued that measures under Article 104 CRD would be less transparent. But it should also be noted, that Article 104(1) CRD gives competent authorities the power to require the disclosure of additional information. It therefore seems possible to achieve the transparency objective, stated by the NBB, applying powers under this Article though this is not the practice in Belgium.
- It is mentioned that the measure is proposed by the NBB for macroprudential purposes while the ECB will be the competent authority to apply Articles 103 and 104 CRD. However, the comments made above are independent of which authority applies the measure.
- The EBA however, acknowledges that Article 104 CRD cannot be implemented as quickly as the proposed measure and the use of article 458 may be warranted in this specific Belgian case.

28. Article 105 CRD as part of the supervisory review process, requires competent authorities to assess whether any imposition of a specific liquidity requirement is necessary to capture liquidity risks to which an institution is or might be exposed. The article is not applicable in this case.

29. Article 133 CRD give member states the right to introduce a systemic risk buffer of Common Equity Tier 1 capital for the financial sector or one or more subsets of that sector, in order to prevent and mitigate long-term non-cyclical systemic or macroprudential risks not covered by the CRR. Given the cyclical and portfolio-specific nature of the proposed measure, as argued by the NBB, this does not seem to be applicable.

30. Article 136 CRD requires designated authorities to assess and set the appropriate countercyclical buffer rate reflecting the credit cycle and the risks due to excess credit growth. As stated by the NBB, Article 136 CRD does not seem to be applicable to the proposed measure since the measure is related to credit growth in a specific portfolio only and would penalise other credit sectors. In particular, it would have different effects on credit institutions depending on the share of retail residential mortgages in their portfolios, which, as stated before, varies significantly from institution to institution.

Article 458(2)(d) CRR

31. A draft legal text was not provided for the proposal but the notification includes the following draft addition to Article 153(3) CRR: 'For retail exposures secured by residential immovable property collateral located in Belgium, the RW shall be equal to the sum of 0.05 and the RW

calculated pursuant the previous paragraph. (This paragraph applies only to Institutions under Belgian law).’ The measure therefore targets and is consistent with Article 458(2)(d)(vi) CRR for a subset (i.e. IRB credit institutions only) of domestically authorised institutions as stated by the NBB.

Article 458(2)(e) CRR

32. Under the assumption that risk weights for residential mortgages are too low for Belgian banks due to the data history used, a review of IRB models as part of the annual backtesting process and as included in the microprudential measures taken by the NBB may be the most effective option. In the medium to long run this could bring the LGD level closer to a level seen as adequate by the NBB. A recalibration can also address bank-specific issues or high-risk sub-segments and maintain the relative risk weights across banks. It can also employ the concept of a downturn LGD higher than the one implied by the historical loss experience in Belgium. However, it might not be possible to implement this in the short term, so that an increase of capital requirements of some form can be required, or the resulting capital level might not be sufficient.
33. Given that, at this stage, there is no evidence of negative impact on the internal market, the EBA does not object to the proposed measure. However, it should be noted that an additive adjustment of risk weights as proposed could have distorting effects. While it does not influence the hierarchy between institutions in terms of risk weights, the increase in relative terms is larger for banks or portfolios with low risk weights. On the one hand, this could potentially penalise institutions with more conservative lending standards. On the other hand, capital requirements for high-risk buckets as mentioned in the notification as a potential source for future losses might not increase enough relative to current capital requirements.
34. Based on the information provided in the notification, it is difficult to assess whether a five percentage point increase is proportionate to the risk for financial stability. It is argued that the add-on will bring the average risk weight of Belgian credit institutions to around 14.6% and therefore closer to other Member States. This is confirmed in Figure 3. However, the appropriateness of this level in light of a potential worsening of conditions in the Belgian housing market should be assessed based on stress testing methodologies and assumed shocks, e.g. decrease in housing prices, increase in unemployment or a change in the tax treatment of mortgages. NBB staff confirmed that the main basis for calibrating the measure was a scenario analysis carried out by the NBB including an assumed house price shock. The scenario was based on an assumed LGD increase of 20% in combination with significantly higher default rates and resulted in additional capital needs respectively losses of EUR 0.8 billion. Given the uncertainty of these results the NBB decided on a slightly lower increase that will be re-assessed over time. The comprehensive assessment carried out by the ECB and the ongoing EU-wide stress test can inform the calibration at a later stage.

Article 458(2)(f) CRR

35. The NBB estimates the total impact of the measures to be EUR 0.55 billion of capital or 2.3% of total capital requirements for Belgian credit institutions using an IRB model. This will increase the resilience of the Belgian banking sector. Data from the NBB also shows that the potential for negative cross-border impacts is limited. Belgian IRB credit institutions represent more than 90% of the market. Additional data provided by the NBB also shows that exposures of foreign branches only represent 0.8% of mortgages loans provided by credit institutions and the majority are branches of credit institutions from Member States participating in the Single Supervisory Mechanism. It should also be noted that the measure was introduced in 2013 without any sign of negative impact on the internal market.

Annex 2: Figures

36. All data included below is sourced from an EBA residential mortgage data collection as of December 2012.

37. Interpretation of data, in particular of data across countries should take into account the number of observations and potential different definitions for reported measures, e.g. the loan-to-value (LTV) ratio or debt service ratio (DSR).

Figure 1: EAD-weighted average IRB risk weights non-defaulted exposure

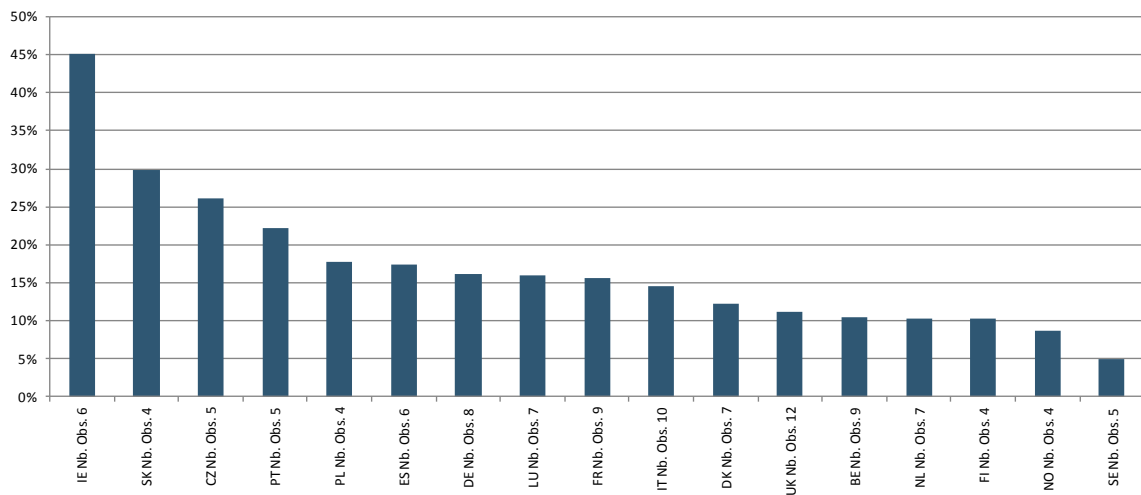


Figure 2: EAD-weighted average PD non-defaulted exposure

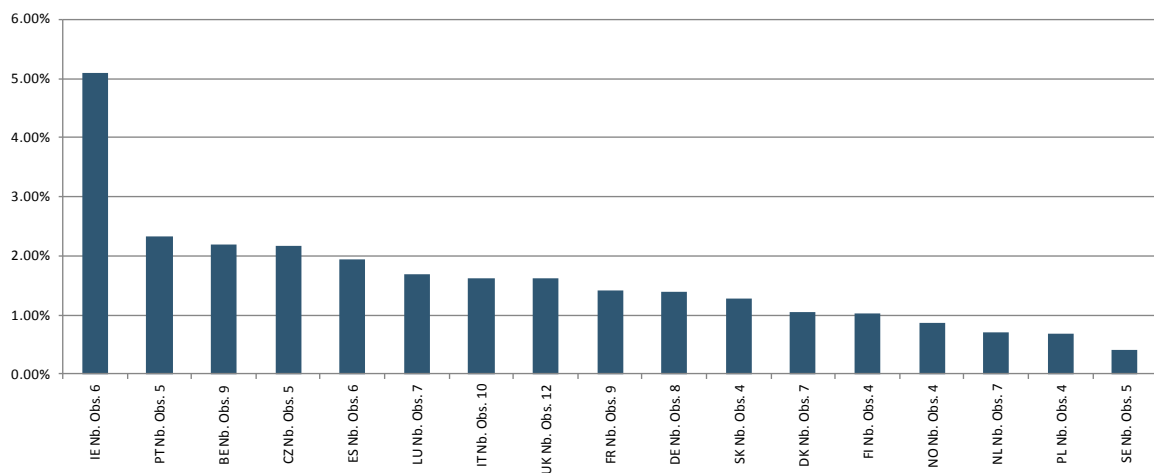


Figure 3: EAD-weighted average LGD non-defaulted exposure

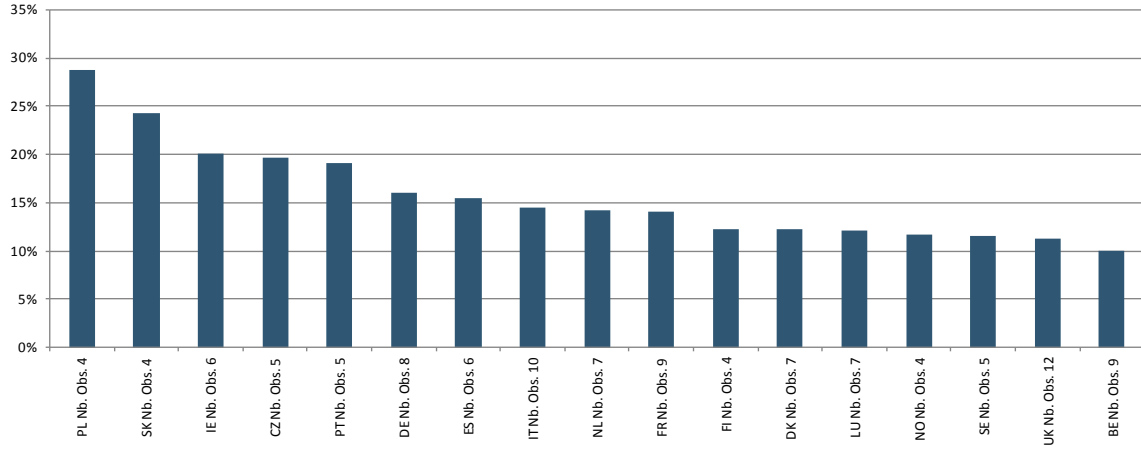


Figure 4: EAD-weighted average LTV at origination vs. EAD weighted average LGD non-defaulted exposure



Figure 5: EAD-weighted average LGD non-defaulted vs. realised loss rates

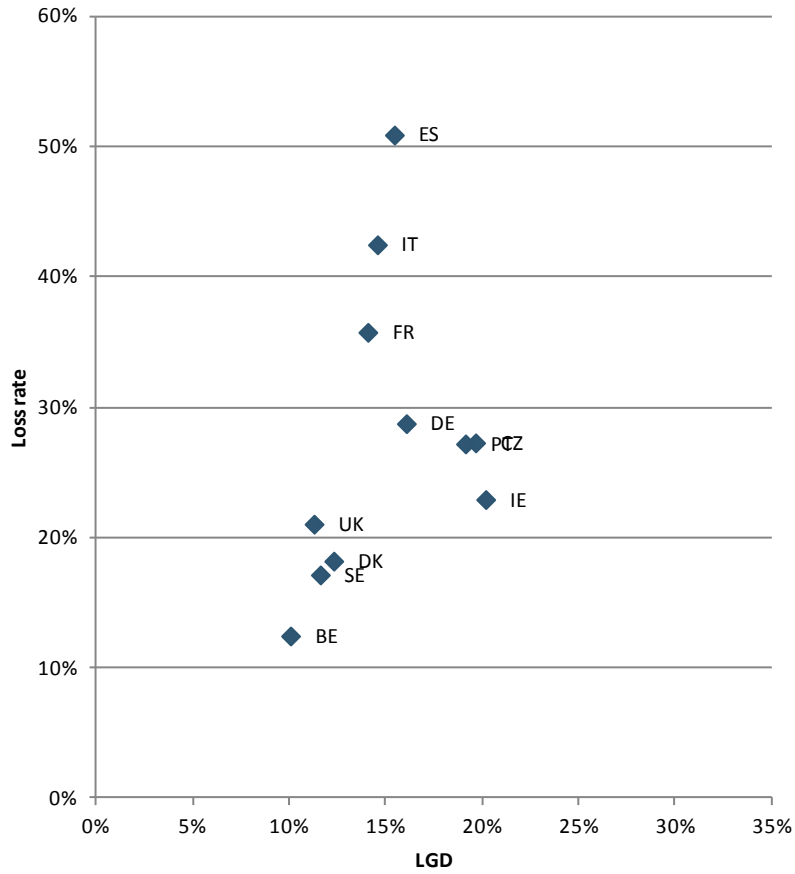


Figure 6: EAD-weighted average risk weight non-defaulted exposure

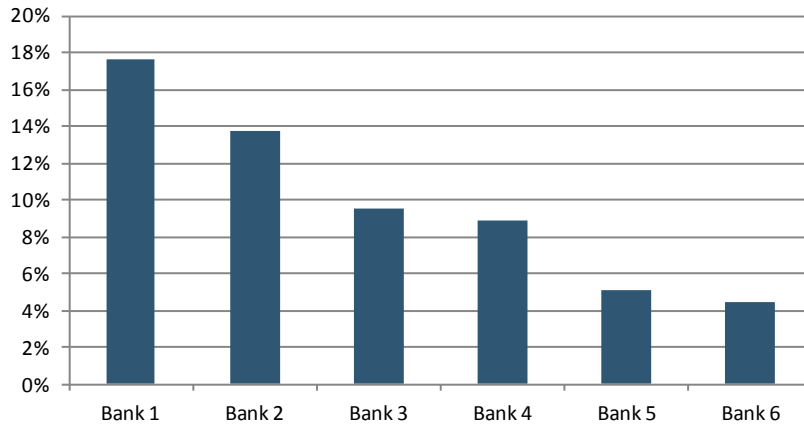


Figure 7: EAD-weighted average LGD floored non-defaulted exposures

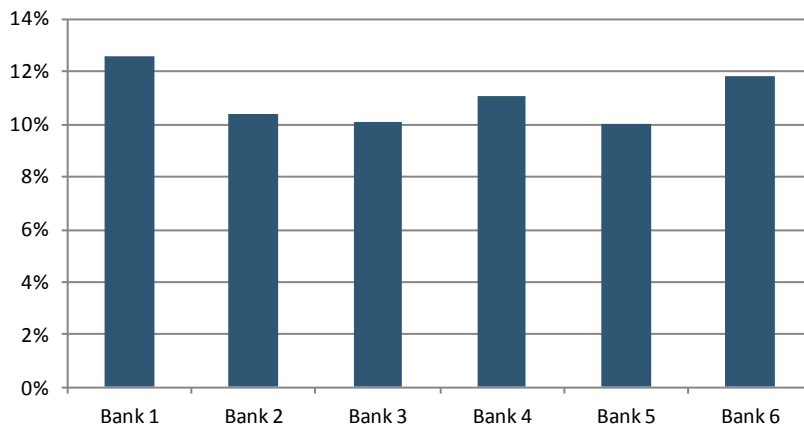


Figure 8: Distribution of LTV at origination buckets by EAD and RWA

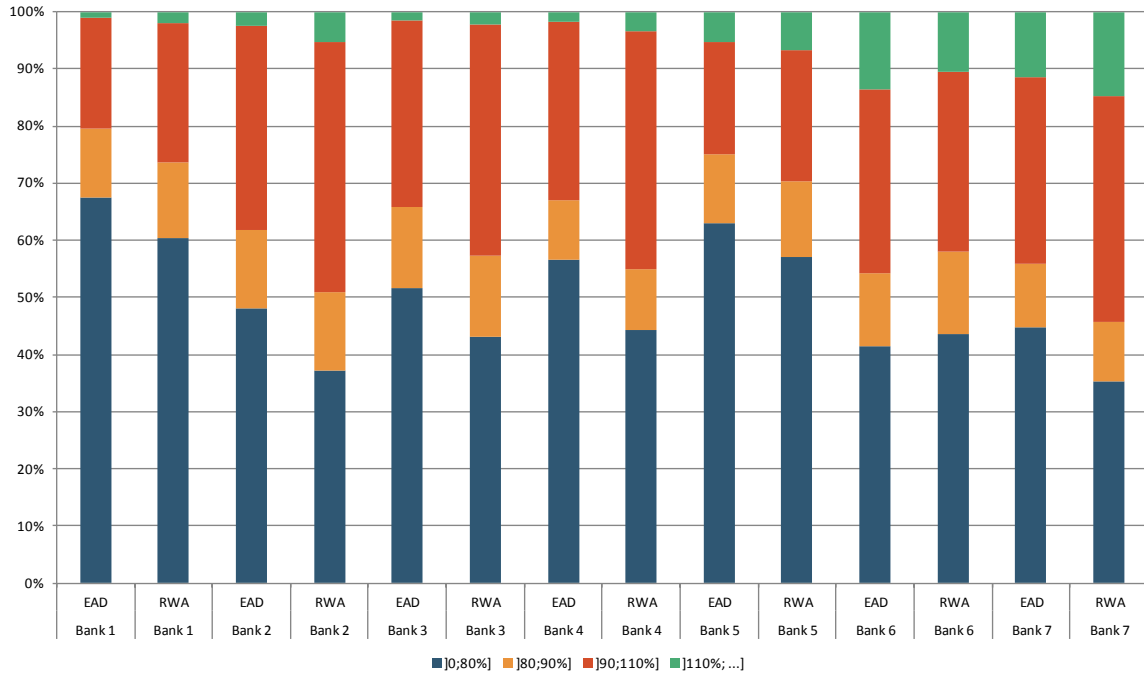


Figure 9: Distribution of debt-service ratio at origination buckets by EAD and RWA

