

EBA-Op-2020-03

Opinion of the European Banking Authority on measures in accordance with Article 458 Regulation (EU) No 575/2013

Introduction and legal basis

1. On 8 January 2020, the EBA received notification from the Central Bank of the Netherlands (De Nederlandsche Bank – DNB), in its capacity as the designated authority for the purpose of Article 458 of Regulation (EU) No 575/2013 of the European Parliament and of the Council (the Capital Requirements Regulation – CRR),¹ of its intention to apply measures referred to in Article 458(2)(d)(vi) of the CRR.
2. The notification includes a proposed stricter national measure for credit institutions authorised in the Netherlands using the internal ratings based (IRB) approach to calculate regulatory capital requirements. More specifically, DNB intends to impose a minimum average risk weight for the calculation of regulatory capital requirements applicable to exposures to natural persons secured by mortgages on residential property located in the Netherlands.
3. The EBA's competence to deliver an opinion is based on Article 16a(1) of Regulation (EU) No 1093/2010 of the European Parliament and of the Council (the EBA Founding Regulation)² and subparagraph (2) of Article 458(4) of the CRR.
4. Article 458(2) of the CRR requires the designated or competent authority entrusted with the national application of that provision to notify the EBA if that authority identifies changes in the intensity of macroprudential or systemic risk in the financial system that have the potential to have serious negative consequences for the financial system and for the real economy in a specific Member State and which that authority considers would better be addressed by means of stricter national measures.

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).

5. Article 458(2)(d) specifically refers to stricter national measures that can be taken to address the level of own funds, requirements for large exposures, public disclosure requirements, the level of the capital conservation buffer, liquidity requirements, risk weights for targeting asset bubbles in the residential property and commercial immovable property sector, and intra financial sector exposures.
6. In accordance with Article 458(4) of the CRR, within 1 month of receiving the notification, the EBA is required to provide its opinion on the points referred to in Article 458(2) to the Council, the Commission and the Member State concerned.
7. In accordance with Article 14(5) of the Rules of Procedure of the EBA, the Board of Supervisors has adopted this opinion.

Background to the measure

8. The measure consists of imposing a minimum average risk weight for IRB banks' exposures to natural persons secured by mortgages on residential property located in the Netherlands. The intention in imposing a minimum risk-weight floor is to enhance the resilience of Dutch banks to a potential severe downturn in the housing market against the background of sustained price increases in real estate over the past few years.
9. According to DNB, mortgage loans covered by the National Mortgage Guarantee scheme³ will be exempt from the measure. This would account for around 20-25% of all mortgage loans in the Netherlands.
10. The measure calculates a risk weight for individual loans based on the loan-to-value (LTV) ratio:⁴

$$Risk\ Weight_i = \begin{cases} 12\% & ,\ where\ LTV_i \leq 55; \\ \frac{55}{LTV_i} * 12\% + \frac{LTV_i - 55}{LTV_i} * 45\%, & \ where\ LTV_i > 55 \end{cases}$$

11. By portfolio, the exposure-weighted average of those calculated risk weights will act as a minimum average risk weight. More specially, a 12% risk weight is assigned to the portion of the loan not exceeding 55% of the market value of the property that serves to secure the loan, and a 45% risk weight is assigned to the remaining portion of the loan. If the LTV ratio is lower or equal to 55, then a fixed 12% risk weight is assigned to the loan. The latter part of the formula ensures that the risk-sensitive part of the floor applies only to loans with an LTV ratio above the current LTV average ratio in the Netherlands. The former part also ensures that the floor is kept relatively high for lower LTV ratios. The continuous approach helps to avoid any distortions due to cliff effects. As in other measures that introduce a minimum risk-weight floor on the retail

³ The Nationale Hypotheek Garantie (NHG) is a public mortgage loan insurance scheme in the Netherlands. The NHG protects borrowers from any residual debt after a foreclosure following a default on their mortgage loan. The NHG covers the outstanding principal, accrued unpaid interest and disposal costs.

⁴ The LTV ratio is defined as the outstanding loan amount divided by the market value of the collateral.

mortgage risk-weighted exposure amounts, this measure affects de facto the total risk-weighted exposure amounts and, in turn, the minimum Pillar 1 capital requirements that IRB banks have to meet at all times in accordance with Article 92 of the CRR.

12. According to DNB, risk weights assigned to Dutch mortgage loans are among the lowest in the EU.⁵ From a macroprudential perspective, DNB considers that they do not accurately reflect the high and persistently increasing systemic risk in the housing market. To assess the impact of a severe housing market correction on banks and to calibrate the floor, DNB has performed a top-down stress test. The stress test uses the adverse scenario that was also used in the EU-wide stress test conducted by the EBA in 2018. In this scenario, Dutch house prices were around 25% lower after 3 years than in the baseline scenario. DNB has performed several analyses to assess the potential impact of a severe housing market correction on banks. First, DNB ran a top-down stress test, which finds that the average risk weight for mortgage loans could increase by as much as 8-11% percentage points in an adverse scenario. Moreover, DNB employed a sensitivity analysis using probabilities of default (PDs) and losses given default (LGDs) to find sizeable losses on banks' mortgage portfolios. Based on these estimates, banks would need to increase their capital by around EUR 3 billion to maintain their current capital levels.
13. The targeted nature and risk-sensitivity of the measure also accounts for proportionality. DNB states that spill-overs to overall credit extension and, indirectly, to the real economy are expected to be limited. The measure would also affect only banks, for which resilience to the indirect effect of a housing bust is likely to be more of a concern than for insurers and pension funds.
14. Only IRB credit institutions would be affected by the proposed measure. The vast majority of retail loans secured by mortgages on immovable property (more than 94%) were issued by the domestic IRB banks in the Netherlands. Therefore, the likelihood of any direct impact on other Member States is small according to the DNB. Moreover, branches of foreign credit institutions using the IRB approach in the Netherlands may also be captured through reciprocation.
15. The application of the measure is expected to increase the average risk weights of IRB banks by 3-4 percentage points (from 11% to 14%-15%). As a result of the increase in risk-weighted assets, the total amount of capital Dutch IRB banks need to hold against their mortgage loan portfolios is estimated to increase by around EUR 3 billion, of which more than EUR 2 billion is CET1 capital.
16. According to DNB, the proposed measure is necessary, suitable, effective and proportionate, and is intended to safeguard financial stability:
 - The main objective of the measure is to ensure that all banks that play an important role in mortgage lending are resilient against a potential severe downturn in the housing market.

⁵ The data are used from the Financial Stability Report of autumn 2019 (https://www.dnb.nl/en/binaries/OFS-najaar2019_ENG_tcm47-385944.pdf) and are based on 2019 Q1 data from the ECB Statistical Data Warehouse.

The additional macroprudential measure helps secure the resilience of the banking sector in a severe downturn scenario.

- The need for an additional macroprudential measure arises because the risk weights applied to real estate exposures by IRB banks are deemed low in the light of growing vulnerabilities at the macro level.
- The proposed measure is targeted at Dutch banks that are highly exposed to high-LTV loans and is intended to cope with negative externalities from the impact of a housing market correction. These loans are more risky not only for banks, in terms of higher credit risk, but also from a systemic perspective. The impact of a housing market correction is expected to be larger when the share of high-LTV loans is larger. In addition, as the measure will impose a higher floor on banks with more high-LTV loans, it gives individual banks a disincentive to grant new high-LTV loans.
- Imposing a fixed risk weight floor makes risky mortgages relatively more attractive for banks than safe mortgages, but DNB is trying to offset this by making the average minimum risk weight risk-sensitive. By imposing a floor rather than an add-on (fixed or through a multiplier), DNB avoids potential distorting effects that could arise from reducing the incentive to estimate conservative risk parameters.

17. The average minimum risk weight would enter into force in the autumn of 2020. The measure is intended to apply for 2 years, after which it would be reviewed and might then be renewed. DNB will ask the ESRB to recommend that other Member States recognise the measure, as their banking sectors may be (or become) exposed to the systemic risk in the Dutch housing market directly or indirectly (through their branches).

Economic rationale for the measure

18. DNB argues that systemic risk inherent in the Dutch housing market has increased over the past few years. DNB sees signs of overvaluation driven by sluggish supply, and declining interest rates partly account for the price increases.

19. House prices have gone up sharply for several years in a row – by almost 8% annually on average in the past 3 years. In the Netherlands' major cities, real prices are now more than 17% above the previous peak level in 2008. In the provinces of North Holland, South Holland, Utrecht and Flevoland – which together account for 44% of all Dutch owner-occupied residential properties – real prices hover around the previous peak.

20. According to DNB, house price increases have significantly outpaced income growth in recent years. As a result, price/income ratios in the major cities are now higher than at the peak of the previous housing market boom. Notwithstanding low interest rates, financing charges (principal repayments and interest payments net of tax relief) have gone up. Riskier behaviour of buyers (such as overbidding) appears to be a relevant factor in price increases. The proportion of

transactions in which the purchase price exceeds the asking price has increased up to 60% in the major cities.

21. DNB argues that the LTV ratios of new loans remain very high. Nearly two thirds of the new loans to first-time buyers have an LTV ratio at or above 90% and almost 40% have an LTV ratio of 100% or more.⁶ Moreover, the percentage of new loans with a loan-to income (LTI) close to their LTI limit has risen steadily over the past few years.⁷ In mid-2019, almost 50% (40% in 2014) of all loans to first-time buyers were at or above 90% of the limit. For home movers a similar situation is observed.

22. In this context, DNB also notes that a loosening of mortgage lending standards in the past few years can be observed. These developments in new loans come on top of persistently high household indebtedness, with mortgage debt of households currently at 91% of gross domestic product (GDP) and households' total indebtedness at almost 102% of GDP in comparison with a euro area average of 55%.

23. According to DNB, banks in the Netherlands are especially vulnerable to a downward correction in the housing market. Banks' expected mortgage loan losses could increase as a direct result of a house price correction. This could be the case if the PDs were to increase, for instance due to a sharp rise in unemployment, while collateral values simultaneously decreased due to the house price correction. The increased risk weights would depress the banks' CET1 capital ratios, which might erode confidence among market participants. Against this background, Dutch banks still depend relatively heavily on market funding. A housing market correction would also hit Dutch banks indirectly, due to the high sensitivity of the Dutch economy to house price shocks. High indebtedness makes Dutch households vulnerable to a downward correction in the housing market. As a result, banks would also suffer from a housing market correction through indirect effects, as the negative economic impact would reduce profitability and increase the risk-weighted exposure amount. Both effects contribute to banks' vulnerability to a house price correction.

24. According to DNB, Dutch banks' resilience to a potential house price correction is crucial to financial stability. All domestic IRB banks are most exposed to risks in the housing market and a large proportion of their assets are Dutch-originated mortgage loans.

25. The objective of the intended measure is to enhance the resilience of banks against a potential severe downturn in the housing market by ensuring that banks hold sufficient capital for residential real estate exposures. The need for this arises from the increase in systemic risk related to the housing market against the background of very low risk weights for real estate exposures by IRB banks. Moreover, the capital impact of the measure is larger for riskier (higher LTV) loan portfolios and therefore could reduce the attractiveness of these loans for banks.

⁶ The LTV limit in the Netherlands was gradually reduced from 106% in 2012 to 100% in 2018.

⁷ The LTI limit for mortgages in the Netherlands is a function of the household income and the mortgage interest rate. Currently, the LTI limit ranges from 3.5 for the lowest income groups to 5.5 for the highest income groups.

Rationale for not using alternative measures

26. The CRR and Directive 2013/36/EU⁸ (the Capital Requirements Directive – CRD) offer various options for addressing macroprudential risks. Article 458(2)(c) and (e) of the CRR require the designated authority to justify why the stricter national measure is necessary and why other possible measures (i.e. under 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.

27. The notification provides a justification of DNB's decision to apply Article 458 of the CRR, in particular for the following reasons:

- Article 124 of the CRR enables the competent authority to increase the risk weights of banks that apply the standardised approach to their mortgage exposures on the basis of financial stability considerations. Article 124 of the CRR does not apply to credit institutions using the IRB approach. Banks using the standard approach represent only a small proportion (around 5%) of all mortgage lending by banks.
- Article 164 of the CRR enables the competent authority to increase the exposure-weighted average LGD floor applied on their mortgage exposures on the basis of financial stability considerations. DNB considers this less efficient and effective than its intended measures because increasing the minimum average LGD floor loans would affect fewer loans with higher LGDs (and so a higher LTV ratio). Moreover, DNB argues that banks with conservative lending standards (implying a lower LGD) would be penalised relatively more than banks with less prudent lending standards, and could be incentivised to align their risk taking with the higher (less conservative) LGD floor. Lastly, DNB is concerned that an increase in the average LGD floor would interfere with the microprudential internal models of banks.
- Article 101 of the CRD states that the competent authority shall review on a regular basis, and at least every 3 years, institutions' compliance with the requirements regarding approaches that require permission by the competent authorities before using such approaches for the calculation of own fund requirements. For significant institutions, this review is performed by the ECB. Despite this, DNB assesses this article as inadequate to address the identified systemic risk. Under the Targeted Review of Internal Models (TRIM), undertaken by the ECB in 2019, the risk weights in the housing sector remain low in the light of the increased systemic risk.
- Articles 103 and 104 of the CRD provide the competent authority with additional supervisory powers (Pillar 2 requirements). DNB believes that the measures enabled by these articles are less effective than the proposed measure because there would not be a clear distinction between microprudential and macroprudential measures, so they would

⁸ 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).

not increase transparency and strengthen accountability. Moreover, DNB argues that the publication of Pillar 2 measures is not mandatory, in contrast to the intended measure, which would allow a beneficial signalling effect enhancing public transparency with effective communication with market participants. Further, DNB submits that the Pillar 2 capital requirement only applies to the outstanding stock, in contrast to the intended measures, which would affect the outstanding stock plus the flow. Therefore, the proposed measure is likely to provide a stronger disincentive to the provision of new high-LTV loans than a Pillar 2 requirement.

- Article 105 of the CRD regards specific liquidity requirements. DNB assesses this measure as not relevant to the risks in question, as the systemic risk the proposed measure aims to address is not linked to banks' liquidity risk.
- Article 133 of the CRD concerns the setting of the systemic risk buffer (SyRB) to address long-term non-cyclical systemic or macroprudential risks not covered by the CRR. DNB argues that the buffer cannot be applied to specific subsectors of exposures and that the application of the SyRB does not allow any differentiation. The SyRB would be imposed on all credit exposures within the Netherlands, and is thus not targeted towards the main source of the increase in systemic risk, the housing market. Moreover, the risk-sensitive approach of the proposed measure, which prices the negative externality of high-LTV loans, is not possible using the SyRB.
- Article 136 of the CRD concerns the setting of the countercyclical capital buffer (CCyB). DNB considers the CCyB less appropriate, effective and proportionate than the proposed measure. Like the SyRB, the CCyB is imposed on all credit exposures within the Netherlands, and would thus not be targeted towards the main source of the increase in systemic risk, the housing market. In addition, the CCyB cannot be narrowed down to a subset of institutions, such as banks using the IRB approach. Moreover, the risk-sensitive approach of the proposed measure is not possible using the CCyB, which applies equally to all domestic exposures. In addition, as DNB notes, there are currently no clear signals of overall excessive credit growth in the Netherlands. Credit growth to the non-financial private sector is in fact negative. The activation of the CCyB would be less appropriate at the current juncture.

Assessment and conclusions

28. Based on the evidence provided by DNB and based on a recent analysis by the European Systemic Risk Board,⁹ the EBA acknowledges the concerns of DNB on the build-up of risk in the residential real estate sector, the large proportion of high-LTV loans and household indebtedness, and the low risk weights for real estate exposures by IRB banks. For this reason, the EBA does not object to the deployment of this macroprudential measure.

⁹ https://www.esrb.europa.eu/pub/pdf/recommendations/esrb.recommendation190923_nl_recommandation~dedbe77acd.en.pdf

29. The EBA supports measures that strengthen the resilience of the banking sector against negative macroeconomic shocks. However, the EBA has some comments regarding the choice of the measure, its calibration and impact. The EBA has in particular the following observations.
30. The EBA has some reservations on the explanation provided by DNB for the calculation of the minimum risk weight because the average LTV ratio (55%) used as a threshold between risky and less risky loans is static while the LTV ratio of the exposure is based on the current market value. The latter will be time-varying and will move along with the value of the underlying property. Against this background, the calibration may tend to be procyclical in nature. Due to the direct dependence of the measure on housing price developments, the minimum average risk weight floor will decrease in upswing phases, since LTVs will decrease, and therefore the proportion of loans above the 55% threshold will tend to be lower, whereas in the downswing phases the minimum average risk weight floor will increase. An increase in the risk weight floor and hence in the risk-weighted assets during the downswing phase may raise unintended consequences that could pose a risk to stability of the Netherlands' banking sector. This seems to be potentially inconsistent with the purpose of a macroprudential measure, even though it is not possible to assess the materiality of such potential procyclicality. The EBA invites DNB to carefully monitor this potential procyclicality, including the relation to the level of risk-weighted assets already resulting from the underlying IRB models, and to consider the deactivation of the measure in crisis time to avoid unintended consequences.
31. In addition, the EBA sees some practical challenges in the reciprocation of the intended measures due to the employing of a non-standardised LTV metric. Any reporting requirement of the measure should be shared with relevant foreign authorities in order to smooth the reciprocation of the measure. Besides, the definition of the LTV metric may differ between the Netherlands and the other Member States. Therefore, some comparability issues may arise.
32. In general, the adjustment of risk weights may have certain negative implications that have already been described in the EBA Report on the range of practices regarding macroprudential policy measures.¹⁰ For instance, measures that adjust risk weights can make risk weights across credit institutions less comparable. The DNB explains that the minimum percentages (12% and 45%) are chosen to ensure that the measure has the desired impact on bank capital. While this fulfils the macroprudential objective of the measure, it also means that at bank-by-bank level the risk weights would depart from banks' estimation of the risks of their portfolios.
33. DNB reports that the calibration aims to increase banks' capital requirements sufficiently to maintain the loss absorption capacity of the banking sector, and it does so through the use of a stress test model. DNB employs the adverse scenario of the 2018 EU-wide stress test foreseeing a severe decline in Dutch house prices. As also stated in the EBA Report on practices regarding macroprudential measures, the use of stress tests to change risk weights can, in certain situations, lead to a double-counting of risks, which might or might not be intended by the relevant authority. This calls for, at least, close monitoring of the impact of the proposed

¹⁰ <http://www.eba.europa.eu/documents/10180/950548/EBA+report+on+the+range+of+practices+regarding+macroprudential+policy+measures.pdf>

measures and its interaction with any Pillar 2 guidance set following the finalisation of the EU-wide stress test.

34. According to DNB, reviewing the permission to use internal approaches under Article 101 of the CRD, aiming to amend IRB parameters, would not be effective because Dutch banks are not in breach of the requirements of the CRR when modelling their Dutch mortgage portfolios. However, the resulting risk weights for residential mortgage exposures in the Netherlands are seen as still too low. DNB stresses that IRB models do not take into account the potential credit losses of Dutch mortgages in a severe downturn scenario. In fact, Pillar 1 requirements are not intended to cover extreme scenarios but should still be appropriate for an economic downturn. In this regard, it should be noted that Articles 101 and 102 of the CRD are meant to address potential deficiencies in the estimation of risk in an institution's internal approach. Moreover, article 180(1)(a) of the CRR requires the PD estimation to use long-run averages of 1-year default rates. In the EBA Guidelines on PD estimation, LGD estimation and treatment of defaulted exposures,¹¹ it is further clarified that the long-run average default rate should be calculated as the average of observed 1-year default rates, if the historical observation period is representative of the likely range of variability of 1-year default rates and, in particular, if the historical observation period contains an appropriate mix of good and bad years.

35. Consequently, it is important that the competent authority encourages Dutch IRB banks to make the appropriate efforts to develop their internal models and address any potential deficiencies making them appropriate to withstand a severe economic downturn. In addition, the EBA would encourage DNB to reassess the rationale for the measure in the light of the outcome of changes in the regulation (the sectoral SyRB, with CRD V) and possible overlap with the output floor.

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

Done at Paris, 6 February 2020

[signed]

Jose Manuel Campa
Chairperson
For the Board of Supervisors

¹¹ The guidelines must apply at the latest from 31 December 2021, but earlier implementation is encouraged. Institutions should engage with their competent authorities at an early stage in order to determine an adequate implementation plan, including the timeline for the supervisory assessment and approval of material model changes, where necessary.