

EBA/Op/2021/06

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EBA Regular Use

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

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## Introduction and legal basis

1. On 18 May 2021, the European Banking Authority (EBA) received notification from the European Systemic Risk Board (ESRB) on the intention of the Central Bank of Estonia (Eesti Pank), the Estonian macroprudential authority, to apply Article 458(9) of Regulation (EU) No 575/2013 of the European Parliament and of the Council (Capital Requirements Regulation, CRR)<sup>1</sup>.
2. This notification concerns the two-year extension of a measure introduced by Eesti Pank in 2019 in application of Article 458(2)(d)(iv) of the CRR to impose a credit institution-specific minimum level of 15% for the exposure-weighted average of the risk weights applied to the portfolio of retail exposures secured by mortgages on immovable property to obligors residing in Estonia. The measure applies to credit institutions that use the IRB approach for calculating regulatory capital requirements.
3. The EBA's authority to deliver an opinion is based on the second subparagraph of Article 458(4) in conjunction with Article 458(9) of the CRR.
4. In accordance with the second subparagraph of Article 458(4) of the CRR, within one month of receiving notification from the designated or competent authority entrusted with the national application of Article 458 of the CRR, the EBA is required to provide its opinion on the points referred to in Article 458(2) of the CRR to the Council, the European Commission and the Member State concerned.

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<sup>1</sup> 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).

5. In accordance with Article 14(2) of the Rules of Procedure of the EBA<sup>2</sup>, the Board of Supervisors has adopted this Opinion.

## Background of the measure to be extended

6. The proposed measure is an extension of credit institution-specific minimum level of 15% for the exposure-weighted average of the risk weights applied to the portfolio of retail exposures secured by mortgages on immovable property to obligors residing in Estonia. The measure applies to credit institutions that use the IRB approach for calculating regulatory capital requirements. The intention is to ensure that banks hold sufficient own funds to cover systemic risks related to housing loans and the residential real estate market and to act as a backstop limiting any further decrease in risk weights.
7. The calibration of the measure is proposed to remain unchanged compared to when the measure was originally implemented. Specifically, the floor of the credit institution-specific average risk weight was originally calibrated on the basis of an assessment of credit losses from housing loans under a stress scenario. According to additional information provided by Eesti Pank, an internal stress test conducted in 2019 and repeated with 2020 year-end data shows that losses from housing loans may amount to 0.7% of total risk exposure. Eesti Pank deems the calibrated floor level of 15% still appropriate in view of the macroeconomic and financial developments since the original adoption of the measure.
8. Currently, there are two IRB banks operating in Estonia, which according to figures provided by Eesti Pank have an aggregate market share of 75% in housing loan stock. The risk weight floor increased the aggregate risk exposure of the IRB banks by 160 million euros, or 2.2%, as at 31 December 2020. The estimated impact on the weighted average CET1 ratio of the two IRB banks was approximately -0.8 percentage points, with the CET1 ratio of the two IRB banks after application of the floor standing at 35.7% at the end of 2020. The floor increases the total risk exposure amount for one bank, while it has not impacted the risk exposure amount of the second bank. Neither of the two banks under scope will be required to raise new capital to meet the additional capital requirements following the extension of the measure.
9. The original measure was notified to the EBA on 15 April 2019, and the EBA provided its Opinion<sup>3</sup> to the Council, the Commission and the Member State on 15 May 2019. In its Opinion dated 15 May 2019, the EBA concluded that the evidence presented by Eesti Pank was not sufficient to support the suitability and appropriateness of the suggested measure. The EBA acknowledged the concerns of Eesti Pank over the build-up of risks in the residential real estate sector. However, the EBA raised several concerns as the evidence presented by Eesti Pank was

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<sup>2</sup> Decision of the EBA concerning the Rules of Procedure of the Board of Supervisors of 22 January 2020 (EBA/DC/2020/307).

<sup>3</sup> Opinion of the European Banking Authority on measures in accordance with Article 458 of Regulation (EU) No 575/2013 of 15 May 2019 (EBA/Op/2019/04), available at <https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2622242/80063715-eeae-4d5f-bc3e-d7b54d0c6136/EBA%20Opinion%20on%20measures%20in%20accordance%20with%20Article%20458%20%28EBA-Op-2019-04%29.pdf?retry=1>

not sufficient to support the suitability and appropriateness of the notified measure including, but not limited to, the following:

- The EBA commented that measures which adjust risk weights can make risk weights across credit institutions less comparable, while measures that adjust risk weights and are calibrated on stress tests can lead to a double counting of risks and capital requirements. Furthermore, the EBA issued a reminder in both its Opinion and a later letter to the Commission<sup>4</sup> that Pillar 2 Guidance could be a way of addressing risks highlighted by a stress test.
- The notified measure was binding only for one of the two IRB banks and it was motivated by the concerns surrounding the variability of risk weights across the two IRB banks, but also by the large difference in risk weights between banks using the Standardised Approach (SA) and banks using the IRB approach. The EBA pointed out that measures under Article 458 of the CRR cannot be used to correct the risk weight sensitivity of individual banks and also stated that level playing field considerations are not a justification for the deployment of macroprudential instruments.
- CRR Article 458 specifies that stricter draft national measures can be enacted when tools set out in the CRR and Directive 2013/36/EU CRD<sup>5</sup> are not as effective as implementing stricter national measures. Eesti Pank, as a designated authority, justified the non-use of some of the other instruments by the fact that those instruments are available only to the competent and not the designated authority (in this case the ECB/SSM). The EBA stated that such a justification does not constitute, in itself, relevant and sufficient evidence of why those instruments cannot be used in cooperation with other authorities. Specifically, Eesti Pank did not provide sufficient justification as to why Article 101 of the CRD was not deemed appropriate.<sup>6</sup>
- Based on the information provided in the notification, activation of the measure was aimed at tackling a structural issue in the Estonian banking sector rather than an increase in the intensity of systemic risk, which would justify the activation of Article 458 of the CRR. However, the EBA acknowledged, following further information exchange with the ECB, that macroprudential indicators on lending and property price dynamics in Estonia could support the view of a gradual increase in systemic risk. Nevertheless, neither Eesti Pank nor the European

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<sup>4</sup> Response of the European Banking Authority to the Commission on the Estonian Central Bank's proposed measure to address macroprudential risk, available at <https://www.eba.europa.eu/eba-responds-to-the-commission-on-the-estonian-central-bank-s-proposed-measures-to-address-macroprudential-risk>

<sup>5</sup> 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. 338–436*.

<sup>6</sup> Due to changes in the CRR that came into force on 28 December 2020, Article 101 of the CRD is no longer an alternative to stricter national measures under Article 458 of the CRR.

Systemic Risk Board (ESRB) saw an asset bubble at that time, while the ESRB had not issued and did not plan to issue a warning or a recommendation to the Estonian authorities as part of its regular monitoring of residential real estate risks across Europe after assessing that the policy package in place was comprehensive, appropriate and expected to be sufficient to address the vulnerabilities identified in relation to residential real estate.

10. The EBA confirmed its Opinion<sup>7</sup> following the request of the Commission dated 26 July 2019 in respect to the revised notification, including Eesti Pank's response to the follow-up questions from the Commission. The EBA saw no material grounds to change its original Opinion on the application of Article 458 of the CRR in Estonia. The EBA highlighted in its response to the Commission that other microprudential measures could be more efficient in tackling the risks identified by Eesti Pank, especially in light of the absence of an asset bubble and the fact that under the then circumstances the risk weight floor was only binding for one bank.

## Opinion on the extension

### Economic rationale for the measure

11. During the last four years, the annual housing loan growth in Estonia has been persistent around 7%, substantially higher than the average growth in the euro area. The Covid-19 pandemic only had a temporary effect as lending growth rebounded strongly during the second half of 2020. Household indebtedness has been relatively stable over the last few years but increased by 3 percentage points in 2020 and remains higher than in peer economies.<sup>8</sup> Similarly, housing price growth slowed to around 4% year on year during spring 2020 and accelerated to 5% in the second half of the year. In 2021, demand in the housing market has further increased, leading to upward pressure on prices. According to Eesti Pank, the likelihood that the housing market is, on average, slightly overvalued has increased compared to 2018.
12. Eesti Pank highlights that despite the seemingly low levels of household indebtedness in comparison to other EU countries, Estonian households are vulnerable since they have lower income and hold lower levels of financial buffers than the EU average. In addition, Eesti Pank is concerned that changes in the second pillar of the pension system could prompt households to take sizeable funds out of the pension system in the second half of the year, which may fuel a further increase in activity and prices if directed to the real estate market.
13. At the same time, the decreasing trend of model-implied risk weights of the two IRB banks has continued since the original application of the measure, reflecting favourable economic

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<sup>7</sup> Response of the European Banking Authority to the Commission on the Estonian Central Bank's proposed measures to address macroprudential risk, available at <https://www.eba.europa.eu/eba-responds-to-the-commission-on-the-estonian-central-bank-s-proposed-measures-to-address-macroprudential-risk>

<sup>8</sup> See Figure 2.10 Household debt-to-gross disposable income ratio from the ESRB April 2021 Risk Dashboard, [https://www.esrb.europa.eu/pub/pdf/dashboard/esrb.risk\\_dashboard210406~8f2090e35d.en.pdf?9c4e43ab79a1581de7db104d9904bddb](https://www.esrb.europa.eu/pub/pdf/dashboard/esrb.risk_dashboard210406~8f2090e35d.en.pdf?9c4e43ab79a1581de7db104d9904bddb)

conditions during recent years and low interest rates that have bolstered loan quality. Compared to 2018, the pre-floor exposure-weighted average risk weight of the IRB banks for retail exposures in Estonia secured by immovable property declined from 13.4% to 12.8% at the end of 2020. Additionally, the impact of the Covid-19 pandemic has not yet manifested itself in loan quality, owing to substantial public sector support measures and loan payment moratoria agreed among banks.

14. Therefore, Eesti Pank views the decline in model-implied risk weights as an indication that the resilience of the banking system to systemic risks related to residential real estate is eroding. The measure is judged by Eesti Pank as proportional since it targets the mortgage exposures of the two IRB banks, which hold the largest share in lending for residential real estate at 75% of housing loan stock and 70% of new housing loans. The measure is also deemed effective as it leads to an increase in the aggregate risk exposure amounts of the IRB banks by 160 million euros and impacts the weighted average CET1 ratio of the IRB banks by approximately -0.8 p.p. The two IRB banks hold capital buffers well above the required level as their weighted average CET1 ratio was 35.7% at the end of 2020. Therefore, neither of the banks has needed to raise new capital to meet the additional capital requirement.
15. Eesti Pank expects the measure to have a limited impact on the functioning of the internal market and does not expect it to trigger leakages. The vast majority of the retail loans secured by mortgages held by the IRB banks have been issued in Estonia, while higher risk weights on housing loans of banks in other countries would disincentivise banks to shift their mortgage exposures. Eesti Pank does not plan to request reciprocation of the measure. Branches of foreign credit institutions held only around 1% of all outstanding housing loans, while the provision of direct cross-border mortgage lending is currently very limited in Estonia.

#### Rationale for not using alternative measures

16. The CRR and 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 suitable, effective and proportionate to address the situation and why other possible measures (i.e. under Articles 124 and 164 of the CRR and Articles 133 and 136 of the CRD) would be less suitable and effective in dealing with the macroprudential or systemic risk identified.
17. Article 124 of the CRR focuses on risk weights for exposures secured by mortgages on immovable property when the standardised approach is used, and thus, it is not appropriate since the measure targets IRB banks. Article 164 of the CRR allows the designated authority to set higher minimum levels for the exposure-weighted average loss given default (LGD) values for retail exposures secured by mortgages on residential property or commercial immovable property. According to Eesti Pank, the decline in the average IRB risk weights of the two IRB banks is not attributed to changes in LGD values, but rather to a decline in probability of default (PD) values due to the benign macroeconomic environment and low interest rates, which have led to favourable credit risk characteristics and have helped to lower default rates.

18. The systemic risk buffer (SyRB, Article 133 of the CRD) would have an impact on all exposures, including, for example, credit to the corporate sector and SMEs. Therefore, such measures would have sizeable side-effects and would not achieve the desired impact of limiting risks related to residential housing loans. With regard to applying the SyRB to sectoral exposures (sSRyB), Eesti Pank argues that the sSRyB would not be efficient in achieving the desired outcome of establishing a floor to prevent a further decline in risk weights. Furthermore, the sectoral buffer requirement would have to be set at a relatively high level to achieve an impact equivalent to the existing measure, disproportionately affecting those banks that are using a more conservative risk weight approach. In addition, Eesti Pank considers that in the current highly uncertain environment, extending the already existing measure is preferable to changing the policy framework and introducing a new capital buffer requirement.
19. The countercyclical capital buffer (CCyB, Article 136 of the CRD) is also not deemed by Eesti Pank to be suited to addressing the risk identified because its purpose is to mitigate the risks arising from excessive credit growth and it is guided by the deviation of the credit-to-GDP ratio from its long-term trend. Further, the CCyB is applied as a percentage of the total risk exposure amount<sup>9</sup>, and thus it is not a suitable instrument for addressing risks related to only a subset of exposures such as housing loans.

## Assessment and conclusions

20. Based on the evidence provided by Eesti Pank in its notification and during subsequent interactions, the EBA acknowledges the concerns of Eesti Pank over the build-up of risks in the residential real estate sector, the risk stemming from the macroeconomic environment and the high concentration of IRB banks in the housing loan market in the country. At the same time, the EBA reiterates its support for measures that strengthen the resilience of the banking sector against negative macroeconomic shocks.
21. Developments in the Estonian housing market do not warrant further loosening of the macroprudential stance.<sup>10</sup> Eesti Pank notes that robust lending growth has resumed, and household indebtedness has increased after being stable for years, based on additional figures provided by Eesti Pank. Moreover, a growing take-up of loans guaranteed by the state-backed KredEx scheme<sup>11</sup> has been observed. Such loans allow a lower down-payment than that generally required by the LTV limits which are currently in place.
22. At this current juncture, Eesti Pank projects a slight overvaluation in the housing market and has issued communications regarding the tightening of requirements for issuing housing loans.<sup>12</sup> Nevertheless, Eesti Pank does not see a bubble in the housing market. Going forward,

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<sup>9</sup> Calculated in accordance with Article 92(3) of the CRR.

<sup>10</sup> This view is shared by IMF staff in the recent Article IV consultation concluding statement. For more details, see here: <https://www.imf.org/en/News/Articles/2021/05/17/mcs051721-republic-of-estonia-staff-concluding-statement-of-the-virtual-2021-article-iv-mission>

<sup>11</sup> <https://www.kredex.ee/en/services/housing/housing-loan-guarantee>

<sup>12</sup> <https://www.eestipank.ee/en/press/signs-overheating-real-estate-market-could-lead-central-bank-review-requirements-issuing-housing-05052021>

expectations of further house price increases are also supported by elevated household savings and changes in the second pillar of the pension system, which allow households to withdraw pension savings. Evidence provided by Eesti Pank in its May 2021 Financial Stability Review<sup>13</sup> shows that as at 31 March 2021, around 20% of participants requested withdrawals of their pillar two pension savings. These funds, when available starting from September 2021, could be channelled to the housing market, leading to larger down-payments, further house price appreciation and ultimately increases in lending.

23. Based on this analysis, the EBA does not object to the two-year extension of the period of application of the measure. During the application period of the original measure, the average risk weights of IRB banks continued to decline further, while risks relating to the housing market have only increased, and the risk weights floor measure therefore provides a backstop. As a result, discontinuing the measure could result in a sizeable decrease of capital requirements for the retail residential real estate portfolio of the two IRB banks at a moment when concerns around the housing market and risks related to residential real estate lending are increasing. Moreover, it is uncertain how defaults and losses on the retail residential real estate portfolio will behave in the aftermath of the Covid-19 pandemic.

24. Moreover, the EBA reiterates its concerns over why other measures laid down in the CRR and CRD cannot address risks to the resilience of the banking system stemming from developments in residential real estate markets. In its original Opinion dated 15 May 2019, the EBA focused, among other issues, on the suitability of Article 101 of the CRD. However, due to changes in the CRR that came into force on 28 December 2020, Article 101 is no longer an alternative to stricter national measures under Article 458 of the CRR. Notwithstanding this, Article 133 of the CRD allows for a SyRB for sectoral exposures (sSyRB), including retail exposures secured by residential real estate. The EBA notes the following:

- The primary motivation for not activating the sSyRB is that it could not act as a floor to prevent future declines in risk weights. However, as stated in the notification, the purpose of imposing a floor to IRB risk weights is also to ensure that the IRB banks hold sufficient own funds to cover systemic risks related to housing loans and the residential real estate market. Using the sSyRB could result in a similar outcome.
- Eesti Pank argues that the sSyRB would disproportionately affect one bank and therefore the risk weights measure is more suitable. The EBA notes that each Member State may introduce a systemic risk buffer of Common Equity Tier 1 capital for the financial sector or one or more subsets of that sector. Different requirements may be introduced for different subsets of institutions and of exposures. Thus, a disproportionate impact could be avoided.

25. Nevertheless, the EBA reiterates its concerns over the calibration of the risk weights measure using a stress test. In the information provided, it is not clarified sufficiently whether the risks

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<sup>13</sup> <https://www.eestipank.ee/en/publication/financial-stability-review/2021/financial-stability-review-12021>

considered by the measure have already been accounted for as part of additional capital guidance (Pillar 2 Guidance). The EBA notes that measures which adjust risk weights and are calibrated based on stress tests can lead to double-counting of risks and capital requirements.

26. In light of the structural nature of risks in the residential real estate market and the trends in the projections of risk weights by IRB banks, the EBA invites Eesti Pank to closely monitor the situation and reassess the appropriateness of the notified measure once risks surrounding the housing market have abated.

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

Done at Paris, 17 June 2021

[signed]

José Manuel Campa

Chairperson  
For the Board of Supervisors