

EBA/Op/2023/04

1 June 2023

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

1. On 2 May 2023, the European Banking Authority (EBA) received a notification from the European Systemic Risk Board (ESRB) on the intention of the Central Bank of Estonia (Eesti Pank), the Estonian macroprudential authority, to extend an existing measure in accordance with Article 458(9) of Regulation (EU) No 575/2013 of the European Parliament and of the Council (Capital Requirements Regulation, CRR).¹
2. This notification concerns the second 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 immovable property to obligors residing in Estonia. The measure applies to credit institutions that use the internal ratings-based (IRB) approach for calculating regulatory capital requirements.
3. The EBA's competence 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.
5. In accordance with Article 14(2) of the Rules of Procedure of the EBA,² 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 Decision of the EBA concerning the Rules of Procedure of the Board of Supervisors of 22 January 2020 (EBA/DC/2020/307).

Background of the measure to be extended

6. The proposed measure is the second extension of a credit institution-specific minimum level of 15% for the exposure-weighted average of the risk weights. The measure applies to the portfolio of retail exposures secured by immovable property to obligors residing in Estonia. The measure applies on an individual and consolidated basis to credit institutions that use the IRB approach for calculating regulatory capital requirements. The measure is aimed at safeguarding the resilience of banks against the systemic risks stemming from lending for residential real estate.³
7. The calibration of the measure is proposed to remain unchanged compared to both when the measure was initially introduced in 2019 and when it was extended for the first time in 2021. Specifically, the floor of the credit institution-specific average risk weight was originally calibrated based on an assessment of credit losses from housing loans under a stress scenario. Eesti Pank deems the calibrated floor level of 15% still appropriate in view of the macroeconomic and financial developments since the first extension of the measure.
8. Currently, there are two IRB banks operating in Estonia, which according to figures provided by Eesti Pank, had a combined market share of 72% in housing loan stock and a share in new housing loans of 64% at the end 2022. The risk weight floor increased the aggregate risk weighted exposure amount of the IRB banks by 196 million euros, or by 2.2%, as of 31 December 2022. The estimated impact on the weighted average CET1 ratio of the two IRB banks was approximately -0.6 percentage points, with the weighted average CET1 ratio of the IRB banks after application of the floor standing at 26.6% at the end of 2022. The two banks under scope will not need 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 Opinion⁴ to the Council, the Commission, and the Member State on 15 May 2019. The first extension of the measure was notified to the EBA on 18 May 2021, and the EBA provided its Opinion⁵ to the Council, the Commission, and the Member State on 17 June 2021.

³ According to additional information provided by Eesti Pank, the share of retail SME exposures secured by immovable property is small in Estonia (2%). Therefore, the subsequent analysis and the description of the macroprudential or systemic risk in the financial system in Estonia focuses on retail loans secured by immovable property granted for house purchase.

⁴ 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-eaae-4d5f-bc3e-d7b54d0c6136/EBA%20Opinion%20on%20measures%20in%20accordance%20with%20Article%20458%20of%20Regulation%20575%20of%202013%20\(EU\)%20\(EBA-Op-2019-04\)%29.pdf?retry=1](https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2622242/80063715-eaae-4d5f-bc3e-d7b54d0c6136/EBA%20Opinion%20on%20measures%20in%20accordance%20with%20Article%20458%20of%20Regulation%20575%20of%202013%20(EU)%20(EBA-Op-2019-04)%29.pdf?retry=1)

⁵ Opinion of the European Banking Authority on measures in accordance with Article 458 of Regulation (EU) No 575/2013 of 17 June 2021 (EBA/Op/2021/06), available at https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Opinions/2021/1015830/EB-A-Op-2021-06
BA%20Opinion%20on%20Estonian%20measures%20in%20accordance%20with%20Article%20458%20of%20Regulation%20575%20of%202013%20(EU)%20(EBA-Op-2021-06)%29.pdf

10. Based on the evidence provided by Eesti Pank in the notification dated 18 May 2021 and during subsequent interactions, the EBA acknowledged in its Opinion, dated 17 June 2021, the concerns of Eesti Pank over the build-up of risks in the residential real estate sector, the risks stemming from the macroeconomic environment, and the high concentration of IRB banks in the housing loan market in the country. Therefore, the EBA did not object to the two-year extension of the period of application of the measure. Nevertheless, the EBA reiterated its concerns over why other measures laid down in the Regulation (EU) No 575/2013 and Directive 2013/36/EU could not address risks to the resilience of the banking system stemming from developments in residential real estate markets. Moreover, the EBA observed that the information provided about the measure calibration did not clarify if risks identified in the scenario analysis were already accounted as part of additional own funds guidance (Pillar 2 Guidance). Therefore, the EBA invited the Eesti Pank to reassess the appropriateness of the notified measure once risks surrounding the housing market have abated.

Opinion on the extension

Economic rationale for the measure

11. According to Eesti Pank, housing market-related vulnerabilities remain one of the main risks to financial stability in Estonia. The growth rate of housing loans was in 2022 almost three times higher than the euro area average according to the information provided by Eesti Pank. House prices increased 24% year on year in Q3 2022 and 17% in Q4 2022. According to Eesti Pank's econometric model for measuring overvaluation in the housing market, housing prices were on average 10% to 15% overvalued in 2022.
12. According to the notification, the rapid growth of house prices has increased household debt servicing costs. Households have taken larger loans compared to their income which is reflected in higher debt-service-to-income (DSTI) ratios, while interest rates for housing loans increased above 4% in December 2022. As most housing loans in Estonia have variable interest rates, higher interest rates pass through to borrowers quickly. Against the backdrop of slowing economic growth, the recent rapid loan growth results in mounting systemic risks as households must cope with higher loan servicing costs. If the economic situation deteriorated unexpectedly, Eesti Pank expects that the increased risks for borrowers could result in higher loan losses for banks.
13. The exposure of the Estonian banking sector to residential real estate risks is high according to the figures provided by Eesti Pank. In 2022, housing loans accounted for 44% of the real sector loan and leasing portfolio, compared to 41% in 2018. Banks are the main providers of housing loans in Estonia while the banking sector is highly concentrated with a few large banks dominating the market.
14. At the same time, Eesti Pank reported that the average risk weight on retail exposures secured by immovable property of the IRB banks in Estonia stabilised at 14.9%, before the

application of the floor. However, according to Eesti Pank, model-based assessments, such as those that underpin the calculation of risk weights, carry a risk that in a rapidly changing environment banks may not be sufficiently prepared if system-wide risks materialised unexpectedly.

15. Eesti Pank considers that the applied risk weight floor is sufficient to mitigate the build-up of risks, while having limited impact on the internal market. According to Eesti Pank, more than 99% of retail exposures secured by immovable property are to obligors in Estonia. Eesti Pank has decided not to ask for reciprocity for the proposed measure because of the limited activity and market share of foreign branches in the Estonian mortgage market.

Rationale for not using alternative measures

16. Regulation (EU) No 575/2013 and Directive 2013/36/EU offer various options for addressing macroprudential or systemic risks. Article 458(2)(c) and (e) of that Regulation require the designated authority to demonstrate that the stricter national measure is suitable, effective, and proportionate, and why other possible measures (i.e., under Articles 124 and 164 of the Regulation (EU) No 575/2013, and Article 133 and 136 of Directive 2013/36/EU) would be less suitable and effective in dealing with the macroprudential or systemic risk identified than the said Article 458.
17. The current notification reiterates the previous justifications for deploying Article 458 of Regulation (EU) No 575/2013. Eesti Pank considers the extension of the measure necessary and that alternative measures are still not adequate to address the identified risk.
 - Article 124 of Regulation (EU) No 575/2013 does not apply to banks using the IRB approach.
 - Eesti Pank considers a measure based on Article 164 of Regulation (EU) No 575/2013 less transparent and with only a limited effect on risk weights. The main reason for Eesti Pank to increase risk weights is not related to the dynamics of LGD values but to lower PD values.
 - Eesti Pank continues to believe that the introduction of a systemic risk buffer under Article 133 of Directive 2013/36/EU would have sizeable side effects while it would not achieve the desired impact of limiting risks related to residential mortgage loans. The reason is that the buffer would apply to all exposures, also to credit to the corporate sector and to small and medium-sized enterprises (SMEs). Regarding the sectoral systemic risk buffer under Article 133 of Directive 2013/36/EU, Eesti Pank argues that applying the buffer only to retail exposures secured by immovable property would not be efficient in achieving the desired outcome of establishing a floor to prevent further decline in risk weights, as the sectoral buffer requirement would have to be set at a relatively high level to achieve the equivalent impact to the existing measure. Moreover,

Eesti Pank argues that it would also affect disproportionately those banks that are using a more conservative risk assessment.

- According to Eesti Pank, the countercyclical buffer rate under Article 136 of Directive 2013/36/EU is not suitable for addressing risks related to only a subset of exposures, such as mortgage loans, because the buffer rate is applied as a percentage of the total risk exposure.

Assessment and conclusions

18. Based on the evidence provided by Eesti Pank, the EBA acknowledges the concerns of Eesti Pank regarding the financial stability risks stemming from housing market vulnerabilities. The EBA recognises that activity levels in the Estonian housing market remain elevated since the first extension of the measure and that financial stability risks have not ceased to exist. At the same time, housing loan growth continued to expand at a pace well above the euro area average and house prices in Estonia remained overvalued according to Eesti Pank analysis. Moreover, the changing macroeconomic environment, characterised by increasing interest rates and strong inflation, poses risks to borrowers' debt servicing capacity. Based on the analysis on the intensity of systemic risk in Estonia, the EBA does not object to the two-year extension of the measure.

19. In Estonia, a large share of loans secured by real estate property has variable rates. According to information provided by Eesti Pank, the rapid housing loan growth is accompanied by a higher share of borrowers with large debt servicing burden compared to when the measure was extended in 2021. Even though the share of household debt to GDP remains constant over the last years, the EBA notes the risks that high indebtedness, high inflation, and increasing interest rates could pose to the debt servicing capacity of households. These risks are all more relevant in the backdrop of slowing economic growth. Thus, the extension of the measure could help prepare banks against a materialisation of loan delinquencies by maintaining the current level of capital requirements.

20. Nevertheless, the EBA reiterates its concerns expressed in its Opinion dated 17 June 2021, over why other measures laid down in the Regulation (EU) No 575/2013 and Directive 2013/36/EU, and in particular the Systemic Risk Buffer (SyRB) and its sectoral version as in Article 133 of Directive 2013/36/EU, cannot address risks to the resilience of the banking system stemming from exposures to immovable property. The EBA has the following observations:

- The SyRB is deemed as less suitable and effective by Eesti Pank because it would also have an impact on the corporate and SME sectors. However, the measure at its current form is applied to all retail exposures secured immovable property, which includes exposures to SMEs. The EBA notes that Article 133 of Directive 2013/36/EU allows applying the SyRB to sectoral exposures or to subsets of any of the sectoral exposures.

Nevertheless, it is important to monitor the impact of this measure on lending to SMEs and to intervene if there are unintended consequences.

- According to Eesti Pank, contrary to a floor, the sectoral systemic risk buffer would not prevent further declines in risk weights. Nevertheless, the primary aim of the measure is to ensure banks hold sufficient own funds to cover systemic risks stemming from lending for residential real estate. The EBA notes that the SyRB and its sectoral version are well suited to increase banks' resilience in the presence of persistent systemic risk. Therefore, the sectoral SyRB could be used to achieve similar objectives.
- Eesti Pank argues that the sectoral SyRB could affect disproportionately those banks that use a more conservative assessment and that targeting systemic risks at the level of the whole banking sector is preferable to tailoring macroprudential measures to individual institutions. The EBA agrees that these measures should target macroprudential or systemic risk in the financial system. However, due to the concentrated nature of the market in Estonia, the measure applied under Article 458 results in an increase in capital requirements only for one bank. Therefore, the EBA would like to note that a similar outcome at the aggregate and individual level could be achieved with the sectoral SyRB. Article 133(5)(f) and (7) of Directive 2013/36/EU allows applying the sectoral SyRB to all exposures and institutions, or one or more subsets of those exposures or institutions, respectively.

21. The EBA would like to reiterate its previous concerns on the calibration of the measure and to make additional observations regarding the relevance of the analysis. The notified measure maintains the original calibration from 2019. The calibration was based on an assessment of credit losses from mortgage loans under a stress scenario.

- The EBA highlights that risk weight measures calibrated based on stress tests can lead to double counting of risks and capital requirements. The additional capital guidance (Pillar 2 Guidance) captures institution-specific risks, and it is not intended to cover macroprudential or systemic risks. In the information provided in the notification, it is not clarified how the identified risks are differentiated from those considered in the additional capital guidance.
- It is unclear whether the assumptions of the scenario analysis conducted for the introduction of the measure in 2019 remain relevant following the change of the macroeconomic and interest rate environment since 2021. Over the past two years, the economy rebounded strongly following the COVID-19 pandemic, while inflationary pressures and the deterioration of the inflation outlook led to the withdrawal of accommodative monetary policies and significantly higher interest rates. These developments have put pressure on households' real incomes and debt servicing costs.

22. The EBA would like to note the divergence of the underlying risk weights of the two IRB banks. Since the first extension of the measure, the average risk weight of the targeted

exposures for the two banks have moved in different directions. The measure is intended to pre-emptively limit further decreases in risk weights. Given the concentrated nature of the market for retail real estate loans in Estonia, the developments in the underlying risk weights should be well understood. In particular, it should be understood whether these trends reflect underlying business characteristics, modelling variations, or shifting risk appetite of the two banks. Moreover, the EBA welcomes any further encouragement of IRB banks established in Estonia to continue developing their internal models and to address any potential deficiencies, in order to build appropriate capacity to withstand a possible materialisation of risks in retail exposures secured by immovable property.

23. In light of the persistent risks in the residential real estate market in Estonia and the changing nature of macroeconomic risks, the EBA invites Eesti Pank to closely monitor the situation and to stand ready to reassess the appropriateness of the notified measure. In this regard, the EBA would like to encourage Eesti Pank to consider measures which can be suitable to address structural vulnerabilities as the identified systemic risks continue to persist.

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

Done at Paris, 1 June 2023

[signed]

José Manuel Campa

Chairperson

For the Board of Supervisors