EBA EUROPEAN BANKING AUTHORITY

EBA/Op/2018/06

25 June 2018

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

Introduction and legal basis

1. On 24 May 2018, the EBA received a notification from Finansinspektionen, the Swedish Financial Supervisory Authority (FSA), in its capacity as the designated authority for the purpose of Article 458 of Regulation (EU) No 575/2013, of its intention to apply measures referred to in Article 458(2)(d) of Regulation (EU) No 575/2013 of the European Parliament and of the Council (the Capital Requirements Regulation – CRR).

2. The notified measure proposes to apply a stricter national measure for credit institutions using the Internal Ratings Based (IRB) approach to calculate regulatory capital requirements applicable to retail exposures collateralised by property in Sweden. More specifically, the Swedish FSA intends to change the risk weight floor method for Swedish mortgages currently applied through Pillar 2 by replacing it with a new method under the provision of Article 458 of CRR.

3. The EBA's competence to deliver an opinion is based on Article 34(1) of Regulation (EU) No 1093/2010 of the European Parliament and of the Council (the EBA Founding Regulation) and subparagraph (2) of Article 458(4) of the CRR.

4. Article 458(2) of the CRR requires designated or competent authorities entrusted with the national application of that provision to notify the EBA if the 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.

5. Article 458(2) 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, or intra financial sector exposures.

6. Within 1 month of receiving the notification, the EBA is required to provide its opinion on the points referred to in Article 458(2) of that Regulation 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. Finansinspektionen intends to modify the current risk weight floor of 25% for Swedish mortgages imposed on IRB banks through Pillar 2 by replacing it with a requirement under the provision of Article 458 of the CRR. The risk weight floor was introduced in 2013 to make sure that the IRB credit institutions fully capture the credit loss risk of Swedish mortgages. First fixed at 15%, the level of the floor was raised to 25% in 2014 to also cover systemic risks related to mortgages. The proposed measure keeps the level of 25% applicable at a portfolio level to the targeted credit institutions. Because this measure consists of an average risk weight floor of 25% on the Swedish mortgage exposures of IRB banks, it will affect 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 according to Article 92 of the CRR.

9. The scope of the measure will not diverge from the current implementation and treatment of the Swedish risk weight floor. The measure will be applied to Swedish exposures collateralised by immovable property within the exposure class ‘retail exposures’. More specifically, it will affect credit institutions (at individual and consolidated level) that have permission to use the IRB approach for exposures to Swedish mortgages. This includes foreign subsidiaries that are credit institutions in Sweden. Branches of foreign credit institutions using the IRB approach in Sweden may also be captured through reciprocity. Currently, 20 credit institutions fall within the scope of the proposed measure.

10. Similarly to the current measure, the risk weight floor of 25% has been calibrated to be sufficient to cover loan losses in Swedish residential mortgages in a severe scenario during a serious financial crisis. In nominal terms, the total capital requirement of credit institutions will remain broadly the same as a result of the new method. On the one hand, the risk weight for Swedish mortgages in Pillar 1 will increase, leading to an increase of the minimum requirement, and, on the other hand, there will be an equivalent decrease in Pillar 2 capital requirements. Overall, the final impact in absolute terms is deemed negligible. However, the impact expressed as a percentage of the risk-weighted assets is more pronounced and is dispersed among the credit institutions. Indeed, the capital ratios will decrease with a magnitude of effect depending on the percentage of Swedish mortgages in the balance sheet.

11. The measure applied at a portfolio level refers to the exposure-weighted average risk weight calculated as the additional risk-weighted assets in accordance with Article 458 of the CRR. Currently, the capital buffer generated by the risk weight floor for Swedish mortgages amounts to SEK 111 billion or 15% of the total capital requirement for the 10 largest IRB banks at the consolidated level.

12. According to Finansinspektionen, the proposed measure is necessary, suitable, effective and proportionate and should safeguard financial stability. It aims to ensure that the banking system is resilient in the event of a severe downturn in the housing market imposing a capital buffer, without restricting the supply of credit. In the meantime, this measure is targeted, as only IRB banks that are highly exposed to Swedish mortgages and residential real estate will be within its scope. The Swedish FSA also argues that the notified measure should ensure a level playing field in the Swedish mortgage market, as it will apply to all banks operating in this sector and should counteract regulatory arbitrage and leakages.

13. This new requirement would come into force on 31 December 2018.

Economic rationale for the measure

14. According to Finansinspektionen, the proposed measure is primarily driven by structural changes in the Swedish banking market. The Swedish FSA's motivation is the decision by Nordea Bank AB (Nordea) to redomicile its parent company to Finland in October 2018, falling under SSM/ECB supervision and the Finnish financial supervisory authority for macroprudential matters. Nordea will continue to operate its retail and commercial banking activities in Sweden through a significant branch of the new Finnish bank and a number of subsidiaries. The Swedish FSA will lose its supervisory power over the group and its branches, as it will become the competent authority of the host Member State, but it will remain competent for the Swedish subsidiaries. Finansinspektionen considers Nordea's decision a structural change to the Swedish banking sector landscape given the size of the bank: Nordea is currently the largest bank in Sweden, with total assets of 120% of the Swedish GDP. It is also one of the major actors in the Swedish mortgage market, holding a 14% share. Finansinspektionen says that keeping the current risk weight floor through Pillar 2 could cause serious distortions in the Swedish mortgage market. Indeed, the Swedish FSA is concerned with the risk that major players in the Swedish mortgage market will face lower capital requirements. This situation could generate additional risks from a financial stability perspective and cause competitive distortions and market dysfunction. Finansinspektionen argues that the proposed measure is necessary to uphold a level playing field and ensure the current level of capital requirement for mortgage exposures in Sweden.

15. More generally, for several years Finansinspektionen has been extremely concerned about the intensification of macroprudential and systemic risks in Sweden stemming from the strong housing market dynamism and the high leverage of Swedish households. Against this background, over time the Swedish FSA has taken various measures to mitigate structural and cyclical vulnerabilities.

16. However, the risks identified when the risk weight floor was initially introduced still prevail. For years the Swedish housing market has shown a buoyant activity over years supported by strong fundamentals, growth in disposable household income and the ultra-low rate environment. Although more stringent regulatory rules have been applied during this time, Finansinspektionen still sees the intensification of macroprudential and systemic risks as a possible threat to financial stability.

17. Swedish banks (mainly IRB ones) are still highly exposed to the residential property sector, and this exposure has continued to grow substantially over the years (with mortgages accounting for 82% of monetary financial institutions' total lending to households and about 68% of the Swedish GDP; 50% of the total lending of the four major banks is mortgage loans to households).

18. House prices have surged rapidly, supported by good access to mortgages and the low-interest-rate environment; in Sweden they have doubled over the past 10 years, leading to an overvaluation of residential properties. Despite the recent correction, the current level of prices remains a source of concern for Finansinspektionen.

19. The high leverage of Swedish households represents a significant vulnerability of the Swedish financial system. For years, the benign financial and macroeconomic environment supported households' credit growth, particularly in the mortgage market. As a result, household indebtedness has accelerated relative to disposable income (household debt was +8.2% in annual terms during 1997-2017, while the average disposable income was up by 4.3%; aggregate household debt accounted for more than 180% of disposable income at the end of 2017, up from around 90% in 1997). Swedish households are even more vulnerable because the majority of mortgages (70%) have floating interest rates, making them particularly sensitive to a sudden rate shock. According to Finansinspektionen, should house prices fall or the interest rate rise, demand for housing and household consumption could amplify the downturn in the economy through the consumption channel.

20. Moreover, Finansinspektionen highlights additional factors that increase the systemic risks. In this respect, the rapid development in the construction of new housing and the competition from new players in the mortgage market with more attractive offers could exacerbate households' indebtedness.

21. Finally, Finansinspektionen is concerned by the second-round effects of a credit supply shock on credit institutions' funding, in particular through the covered bonds market.

22. In the light of the aforementioned elements, the Swedish FSA deems it necessary to safeguard credit institutions with capital buffers from a potential downturn in the housing market. The latter may lead to negative repercussions not only for banks and for households, but also in turn for the Swedish economy as a whole and for the entire region, given the interconnectedness of Swedish banks with their Nordic and Baltic counterparts.

23. By moving the current risk weight floor from Pillar 2 to the framework of Article 458 of the CRR, Finansinspektionen aims to ensure a level playing field and safeguard capital requirements. In

particular, the Swedish FSA makes the assessment that using Article 458 of the CRR will enable the measure to be reciprocated, as the process is clearly designed contrary to Pillar 2 requirements. In that case, branches of non-Swedish banks with exposures to Swedish mortgages may be affected by the new requirements should the home countries decide to reciprocate the Swedish measure.

Rationale for not using alternative measures

24. The CRR and Directive 2013/36/EU (CRD) offer various options for addressing credit institutions' vulnerabilities: Article 458(2)(c) of the CRR requires the designated authority to justify why the stricter national measure is necessary and why other possible measures (i.e. Articles 124 and 164 of the same Regulation 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.

25. The notification provides a justification of the Swedish FSA's decision to deploy Article 458 of the CRR, in particular the following reasons:

- Article 124 of the CRR does not apply to credit institutions using the IRB approach.

- Increasing the LGD floor for mortgage loans as per Article 164 of the CRR is believed not to adequately and effectively address the identified systemic risk if this is applied instead of the proposed approach. According to the Swedish FSA, this is because increasing the LGD floor for mortgages would widen the differences in risk weights among IRB banks and result in a disproportionate increase in risk weights for some banks, leading in particular to unwanted effects on the banks with the highest initial PDs. Additionally, to have the same impact as the proposed measure of a risk weight floor of 25%, the minimum LGD would need to be raised by more than a multiple of 5, i.e. to more than 50% in comparison with the current 10%. Moreover, an increase in the average LGD floor under Article 164 would, among other implications beyond the calculation of risk-weighted exposure amounts, also apply to the calculation of expected loss amounts as per Articles 158-159 of the CRR. Finally, the Swedish FSA writes that using Article 164 would add further complexity to the determination of capital requirements and could reduce the transparency of IRB risk weights for market participants.

- Article 101 of the CRD would not be applicable, as Swedish banks using IRB models are not in breach of the CRR's requirements when modelling their Swedish mortgage portfolios. The Swedish FSA states that IRB models are developed using long time series of internal historical data from their Swedish mortgage portfolios, which reflect the extremely low credit losses from Swedish mortgages that the banks have experienced since the financial crisis at the beginning of the 1990s. In response to the low risk weights of Swedish mortgages, Finansinspektionen intends to perform 'bottom-up repair' measures that would allow a review of IRB models for Swedish mortgages. This would ensure, among other things, that the cycle and downturn adjustment used when calibrating PD and LGD are

sufficient, but they are not expected to increase the risk weights to anywhere near the 25% floor level. Nevertheless, although these reforms may gradually push risk weights up over a number of years, realistically they will not come into effect in the near future. Finally, the Swedish FSA states that any increase in risk weights in the IRB models would not lead to any double counting, but rather the impact of the floor would decrease to the benefit of the modelled risk weights.

- Articles 103 and 104 of the CRD are the ones currently used for the application of a risk weight floor on Swedish mortgage exposures. Nevertheless, Finansinspektionen writes that Nordea's decision to move its head office from Sweden to Finland implies significant changes to the current situation; to uphold resilience and safeguard financial stability, as well as counteract a distortion in the market competition, the way the risk weight floor is currently applied needs to be changed. The main reason for this is that the responsibility for supervising Nordea with regard to capital, liquidity and risk management will lie with the SSM/ECB, whereas Finland's supervisory authority will be responsible for macroprudential policy. Finansinspektionen assesses that the SSM/ECB supervision practices make it highly unlikely that the authority will be able to apply the Swedish risk weight floor in Pillar 2 as it is designed today, even though the request and achievement of reciprocity of capital requirements in Pillar 2 could be attained within the framework of the supervisory colleges. Especially considering that the capital adequacy regulations do not clearly define reciprocity for Pillar 2 requirements, whereas Article 458 of the CRR contains a predefined process for the designated authorities in EU Member States to request reciprocity, the Swedish FSA states that a measure under Article 458 would be the right approach to preventing Nordea, by moving its head office to Finland, from being subject to lower capital requirements for its Swedish mortgage exposures than at present. Article 105 of the CRD would not be applicable because its focus is on specific liquidity requirements, which is not relevant for the purposes of the proposed measure.

- Regarding Article 133 of the CRD (systemic risk buffer – SRB), Finansinspektionen writes that it already applies an SRB of 3% to the four major banks, which addresses the structural risks associated with the large, concentrated and interconnected banking sector in Sweden. Nevertheless, as the risk weight floor measure is proposed in response to the elevated and increasing cyclical risks in the residential real estate market – whereas the SRB's objective is preventing and mitigating long-term, non-cyclical systemic or macroprudential risk not covered by the CRR – the Swedish FSA believes that this would not address the identified risk adequately, effectively or proportionately if it were to be used instead of Article 458 of the CRR. Another reason for this is that the SRB is not designed to apply to specific exposures, such as residential mortgage credit exposures, within a Member State. Applying this instrument, therefore, risks penalising other exposures, including corporates. The same reasoning is used for Article 136 of the CRD (countercyclical capital buffer, currently set at 2% in Sweden), which applies to the aggregate credit stock, whereas the risk identified concerns real estate mortgages only. This would penalise credits and other exposures to SMEs and corporates, which are not the target of the measure. Moreover, it would penalise those banks with the smallest proportion of relevant exposures in mortgage loans.

Assessment and conclusions

26. Based on the evidence provided by the Swedish FSA, and also on the recent analyses by the European Systemic Risk Board,[1] the EBA acknowledges the macroprudential risks in the Swedish economy related to residential mortgage loans and residential mortgage indebtedness and it does not object to the deployment of macroprudential measures.

27. However, the EBA sees some ongoing issues regarding the rationale, the calibration and the impact of the measure, which it would like to bring to the attention of the European Commission.

28. The notification states that reviewing the permission to use internal approaches under Article 101 of the CRD, aiming to amend IRB parameters, would not be effective because Swedish banks are not in breach of the requirements of the CRR when modelling their Swedish mortgage portfolios. However, the resulting risk weights for residential mortgage exposures in Sweden, at 4.5%, are seen as still too low. It says that this is because IRB model estimates are based on the extremely low historical credit losses from Swedish mortgages and do not take into account the potential credit losses of Swedish mortgages in a severe downturn scenario. In this regard, a review of internal models based on Articles 101 and 102 of the CRD could also be an effective measure to increase risk weights. This is also stated in the notification, where Finansinspektionen explains that it intends to review the IRB models through 'bottom-up repair' measures, which are seen as long-term efforts but realistically will not come into effect in the near future. The EBA welcomes the early planning of such measures and acknowledges the time horizon for carrying out such reviews. However, the EBA believes that any review of internal models should be put in place in parallel with a review of the proposed measure, if approved, to assess if a potential increase in risk weights resulting from a review of internal models might lead to the reassessment of the appropriateness of the present floor.

29. As using Article 458 of the CRR has to be proposed as a consequence of a change in the intensity of the macroprudential or systemic risk as required in the CRR, the notification could be more extensive on the recent change that triggered this proposal. In this case, the event should be the trigger of a move from a measure under Article 104 of the CRD to Article 458 of the CRR. If such event is seen in the consequences of the decision by Nordea to move its legal domicile from Sweden to Finland, a reasoning based on changes in governance shall not be taken as an adequate justification for the change in regulatory framework.

30. In addition, the notification includes several references to the fact that, once the move is finalised, the supervisory practice of the SSM/ECB will make it highly unlikely that the same floor will be applied in Pillar 2 for Nordea. First, the EBA sees the need for caution about the central role of reciprocity as one of the key reasons for the shift. Moreover, the EBA deems it inappropriate to preempt a future supervisory decision of any other authority, which should be

[1] https://www.esrb.europa.eu/pub/pdf/warnings/161128_ESRB_SE_warning.en.pdf?2bd62f6993bfa203e7072aea47e74085.

built on a comprehensive risk-based approach, taking into account the specificities of the institutions concerned and the various risks that could undermine the viability and sustainability of the whole entity. In addition, although there is currently no explicit reciprocity mechanism for Pillar 2, as there is for Article 458 of the CRR, the EBA reminds that the current mechanisms of cooperation/coordination laid down in Article 51 of the CRD, the RTS and ITS[2] on functioning of colleges and the RTS on exchange of information[3] between home and host competent authorities imply that competent authorities of host Member States with significant branches are members of the supervisory college. Consequently, reciprocity of capital requirements in Pillar 2 can be part of the discussion among members of supervisory colleges. Moreover, the EBA supports a close cooperation between the different authorities to apply or even take further actions helping reciprocity in accordance with the legislation in their jurisdiction to ensure that any additional systemic risk is contained.

31. The notification states that the proposed measure will not generate any additional capital for banks, as the new proposal was calibrated to keep capital requirements neutral in absolute terms. However, the impact on the total capital requirement as a percentage of the risk-weighted exposure amounts will be significant, as the capital ratios will decrease substantially, particularly for small banks. Moreover, the proposed measure reduces the current margin for triggering the automatic dividend restrictions. Therefore, although it is clear that the estimated impact of the proposed measures is technical and does not point to any negative impact on Swedish banks' capital position, the EBA draws the attention of the Swedish authorities to the communication challenge stemming from the proposed measure to avoid any misperception by the financial markets.

32. Related to the point above, the impact assessment shows a wide dispersion among the banks in scope, within a range of 1.9% to 28.7%. This redistribution of capital requirements and capital levels shows that the impact on Swedish banks would be considerably higher than that on Nordea if Article 458 of the CRR were applied. In addition, looking at Nordea's specific case and its future capital requirements as provided by Swedish authorities, the EBA sees a need for greater clarity regarding how the additional 2% systemic risk buffer, currently applied to systemically important institutions in Sweden under Pillar 2, will be implemented after the relocation of Nordea to Finland.

33. In general, the adjustment of risk weights has certain negative implications that have already been described in the EBA report on the range of practices regarding macroprudential policy measures[4] and that should also be considered in this instance:

- Measures that can make risk weights across credit institutions less comparable.

[2] COMMISSION DELEGATED REGULATION (EU) 2016/98 of 16 October 2015 supplementing Directive 2013/36/EU of the European Parliament and of the Council.

[3] COMMISSION DELEGATED REGULATION (EU) No 524/2014 of 12 March 2014 supplementing Directive 2013/36/EU of the European Parliament and of the Council.

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

- Measures that are calibrated based on stress tests can lead to a double counting of risks and capital requirements in following stress-testing exercises.

34. Finally, the EBA invites the Swedish authorities to closely monitor the consequences of the structural changes mentioned beyond competitive distortions and to assess the impact from a systemic risk perspective. Special attention should be paid to households' credit growth resulting from new competition that could weigh even further on the households' indebtdeness. It is also noted that the calibration of the proposed measure is said to be the same as that of the current risk-weighted floor for Swedish mortgages (25%), but the notification does not mention the underlying rationale for keeping the same floor level under Pillar 1. In this respect, the EBA sees the need to carry out a further specific analysis as part of the close monitoring of the appropriateness of the proposed measure with the risks surrounding the Swedish mortgage and residential real estate markets.

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

Done at London, 25 June 2018

Andrea Enria

Chairperson
For the Board of Supervisors