

EBA-Op-2019-04

15 May 2019

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

Introduction and legal basis

1. On 15 April 2019, the EBA received notification from the Central Bank of Estonia (Eesti Pank), 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) of the CRR.
2. The notification includes a proposed stricter national measure for credit institutions authorised in Estonia using the internal ratings based (IRB) approach to calculate regulatory capital requirements applicable to the portfolio of retail exposures secured by mortgages on immovable property to obligors residing in Estonia. More specifically, Eesti Pank intends to set a credit institution-specific minimum level of 15% for the exposure-weighted average of the risk-weights applied to that portfolio.
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)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

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).

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, and 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 the CRR to the Council, the Commission and the Member State concerned.
7. This opinion is drafted based on the information provided by Eesti Pank in its notification and through subsequent follow-up discussions with relevant Eesti Pank staff and with the European Central Bank/Single Supervisory Mechanism (ECB/SSM), the relevant competent authority.
8. 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

9. The measure consists of setting a minimum level of 15% for the average risk weight on retail exposures secured by mortgages on immovable property applicable to credit institutions that have adopted the IRB approach. The intention in setting an average risk-weight floor is to uphold the resilience of banks by ensuring that they hold sufficient own funds to cover systemic risks related to the residential real estate market.
10. The measure targets residential mortgage loans whose obligors are located in Estonia. Because this measure consists of an average risk-weight floor of 15% on the retail mortgage risk-weighted exposure amounts of Estonian IRB banks, it may 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 in accordance with Article 92 of the CRR.
11. The calibration of the floor was carried out using a macroeconomic stress test, in which a shock similar to that which affected Estonia in 2008-2009 in the wake of the global financial crisis was assumed (i.e. a cumulative fall in real gross domestic product (GDP) of 20%, a reduction in house prices of 50% and an increase the unemployment rate of 20%). The estimated increase in the loan loss ratio for housing loans in reaction to the shock (to 1.4%) would give an estimated minimum level for the average risk weight for residential mortgage loans of 16%, given the minimum requirement for capital for Estonian banks. However, given the wide confidence interval and the current economic environment, the minimum average risk-weight floor was set at 15%, as the objective of the measure was to establish a floor to limit further reductions in risk weights.

12. The direct negative spillovers from the proposed measure to other bank activities, such as corporate financing, would be limited, as the measure would apply only to retail exposures secured by real estate property.
13. Two credit institutions would be affected by the proposed measure. The two IRB credit institutions in Estonia (which are subsidiaries of foreign banks) hold 75% of the total housing loan market and issued 80% of total new housing loans in 2018. The vast majority of retail loans secured by mortgages on immovable property held by the IRB banks were issued in Estonia (more than 99%). Therefore, the likelihood of any direct impact on other Member States is small.
14. The application of the measure would increase the aggregate risk-weighted exposure amount of the IRB banks by EUR 140 million or 2.2%. The estimated impact on the weighted average Common Equity Tier 1 (CET1) ratio of the IRB banks would be a decrease of approximately 0.8 percentage points (pp.). As both Estonian IRB banks held capital buffers above the required level with a weighted average CET1 ratio of 39.2% at the end of 2018, neither of them would be expected to raise new capital to meet the additional capital requirement.
15. According to Eesti Pank, the proposed measure is necessary, suitable, effective and proportionate, and is intended to safeguard financial stability:
- The measure is intended to limit any further and potential reductions in risk weights to uphold the resilience of the banks and to ensure that they hold sufficient own funds to cover systemic risks related to mortgage loans and the residential real estate market. According to the Eesti Pank, the measure will ensure that the systemic risk buffer (SRB), the other systematically important institutions (O-SII) buffer and the countercyclical capital buffer remain effective if risk weights decline further.
 - As mentioned in the notification, another aim of the measure is to ensure a level playing field in the Estonian market. Setting an exposure-weighted average risk-weight floor for IRB banks limits any unjustified increase in the differences in risk weights between the two IRB banks and between the IRB and standardized approach (SA) banks. According to the notification, the housing loan portfolios of the IRB banks in Estonia are similar and do not justify significant differences in the average risk weights.
16. The minimum level would enter into force on the third quarter of 2019. The measure is intended to apply for 2 years, after which it would be reviewed and might then be renewed. No reciprocation is requested.

Economic rationale for the measure

17. The two IRB banks have increased their share of total housing loans in Estonia from 71% in 2013 to 75% in 2018. The share in new housing loans was even higher, at 80%, in 2018. Meanwhile, the exposure-weighted average risk weight on retail exposures secured by immovable property in Estonia has declined from 17.8% to 13.4% in the past five years. In addition, Eesti Pank notes

that the average risk weight at one IRB bank was in 2018 1.8 times larger than that at the other bank, although the housing loan portfolios of the banks are similar.

18. Eesti Pank argues that the falling risk weights on mortgage loans reflect a prevailing period of favourable economic circumstances, during which the central bank observed a reduction in overdue loans. Nevertheless, Eesti Pank notes that the lending dynamics, real estate developments and business cycle indicators do not show any decrease in the level of cyclical risk.
19. In this context, Eesti Pank notes the measure is intended to limit any further and potential reductions in average risk weights in a precautionary manner. In particular, Eesti Pank is concerned that the capital buffers of the IRB banks would not be sufficient to withstand the potentially large loan losses that could follow a severe downturn in the real economy if the banks have underestimated the systemic risks related to lending for residential real estate.
20. According to Eesti Pank, the level of risk stemming from the macroeconomic environment and from the residential real estate market in particular has not decreased. In the past 3 years, real estate prices have grown annually by 5.2% on average for residential real estate, while the volume of housing loans grew 6.5% on average in the same period. The residential estate prices have recently slowed, and new housing loans have been growing at a slower pace than in previous years. Nevertheless, Eesti Pank sees a risk that the current low unemployment rate and the rapid growth in wages may increase the growth of house prices further, and that, combined with the current low interest rate environment, this could accelerate the growth of housing loans and household debt.
21. According to Eesti Pank, the Estonian banking sector is highly sensitive to negative developments in the residential real estate market. In 2018, housing loans amounted for 29% of Estonia's GDP. This share is 8pp lower than a decade ago. In the banking sector, housing loans amounted to 41% of total loans (5pp higher than a decade ago) and 29% of total assets. Compared with the EU average, the share of housing loans in total loans and in total assets are approximately 1.5 times and 2 times larger, respectively, according to Eesti Pank.
22. Eesti Pank argues that the resilience of IRB banks is crucial to ensure a smooth supply of credit in negative macroeconomic scenarios due to their significant market share in the housing loan market.

Rationale for not using alternative measures

23. The CRR and Directive 2013/36/EU (the Capital Requirements Directive - CRD) offer various options for addressing macroprudential risks. Article 458(2)(c) and (e) of the CRR requires 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 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.

24. The notification provides a justification of Eesti Pank's decision to apply Article 458 of the CRR in particular for the following reasons:

- Article 124 of the CRR does not apply to credit institutions using the IRB approach.
- Eesti Pank is not entitled to apply any measures under Article 164 of the CRD as the article extends such powers only to the competent authorities. Nevertheless, the lower risk weights for mortgage loans in Estonia have been the result of a fall in the probability of default (PD) rather than in the loss given default (LGD) estimates. The average LGD rates have fallen by less and are more homogeneous between the two banks.
- Eesti Pank is not entitled to review or assess whether credit institutions are using well-developed and up-to-date techniques and practices for internal approaches, or take measures in this regard as stated in Article 101 of the CRD.
- Because the measure is not based on the supervisory review and evaluation process and because measures under Articles 103 and 104 of the CRD are not available to Eesti Pank, those instruments were not considered. Nevertheless, the aim of the measure is to safeguard the resilience of the banking sector against the impacts of potential negative scenarios, which, according to Eesti Pank, cannot easily be captured by models based on historical data.
- Regarding Article 133 of the CRD (the SRB), the buffer cannot be applied to specific subsectors of exposures. The aim of the measure is to target risks stemming from domestic mortgage loans. The application of the SRB does not allow any differentiation between the sectors affected and therefore it cannot be used for this purpose.
- Like the SRB, the countercyclical buffer rate cannot be applied to subsectors such as residential real estate.

Assessment and conclusions

25. The EBA acknowledges the concerns of Eesti Pank on the build-up of risk 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.

26. The EBA notes also that the two banks covered by the measure hold capital buffers well above their required levels, as their weighted average CET1 ratio was 39.2% at the end of 2018. The estimated impact of the proposed measure on the weighted average CET1 ratio is a decrease of approximately 0.8 pp. Consequently, Eesti Pank does not expect the banks to raise additional capital to meet the additional capital requirements.

27. The EBA supports measures that strengthen the resilience of the banking sector against negative macroeconomic shocks. However, the evidence presented by the designated authority (both in the notification and during the ensuing interactions with Eesti Pank) is not sufficient to support

the suitability and appropriateness of the suggested measure to address the targeted risk in this particular case. The EBA has in particular the following observations.

28. 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*³ and that should also be considered in this instance:

- Measures that adjust risk weights can make risk weights across credit institutions less comparable.
- Measures that adjust risk weights and are calibrated based on stress tests can lead to a double counting of risks and capital requirements.

29. According to Eesti Pank, the suggested risk-weight floor is a precautionary measure against further and potential reductions in the average risk weights on an aggregate level. If put in place, the measure would be binding on only one of the two targeted IRB banks (as only one of them currently has risk weights below the suggested floor).⁴ Eesti Pank expressed the concern that the risk weights for these banks differ considerably although they have similar retail portfolios and that the lower average risk weight of one of the IRB banks does not seem to be justified. Therefore, despite the declared macroprudential objective of the measure, the risk-weight floor could be seen more as a way of adjusting the risk sensitivity in the internal model of a specific bank and thereby reducing the existing difference in the average risk weights. The EBA takes note of the competent authority's view that such differences in risk weights should not be considered per se to indicate unwarranted risk-weight variability. It also notes that Pillar-2 guidance could be a way of addressing potential risks highlighted by a stress test.

30. In addition, according to the notification, another aim of the measure is to ensure a level playing field in the Estonian market between IRB banks and SA banks. Nevertheless, level playing field considerations are not a justification for the deployment of macroprudential instruments, and it remains unclear whether microprudential measures would not be more fit for purpose.

31. From a legal perspective, Article 458 of the CRR can be activated only subject to strict formal and substantive conditions. For the same reason, the designated authority is required to justify its choice of a measure under Article 458 as opposed to other available instruments. Eesti Pank, as a designated authority, justifies the non-use of some of the other instruments by the fact that those instruments are available only to the competent authority (in this case the ECB/SSM). Such a justification does not constitute, in itself, relevant and sufficient evidence of why those instruments cannot be used in cooperation with other authorities. For example, the notification does not explain why the application of Article 101 of the CRD was not deemed appropriate.

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

⁴ Based on the Common Reporting Framework (COREP) information and as confirmed by Eesti Pank. The EBA acknowledges that even though the measure would be binding on only one bank, it might act as a backstop also for the second IRB bank should risk weights decline.

Eesti Pank mentions in the notification that it has consulted the competent authority on the measure without conveying the assessments resulting from the consultation. After receipt of the notification, the EBA was informed of the discussions between Eesti Pank and the ECB/SSM on whether there were microprudential concerns over these risk weights (i.e. whether the institutions met standards for individual safety and soundness). The EBA was informed that the ECB/SSM did not see the need for additional microprudential action beyond that already underway in the context of TRIM, which is currently ongoing.

32. The use of risk weights according to Article 458(2)(d)(vi) of the CRR is meant to target asset bubbles in residential real estate. However, neither Eesti Pank nor the European Systemic Risk Board (ESRB) see an asset bubble in the Estonian residential real estate at the moment. In this regard, in the latest ESRB assessment of vulnerabilities in the EU residential real estate sector (November 2016), the overall macroprudential assessment was that the policy package in place in Estonia was comprehensive, appropriate and expected to be sufficient to address the vulnerabilities identified in relation to residential real estate. Moreover, the EBA takes also note that the ESRB is currently not preparing a warning or a recommendation on residential real estate risks to the Estonian authorities as part of the ESRB's regular monitoring of residential real estate risks across Europe.

33. In this regard, the EBA acknowledges that this is a pre-emptive measure intended to limit a reduction in the loss absorption capacity of the two IRB banks (and possible future IRB banks) with the largest share of housing loans, if risk weights were potentially to decline further in the event that related risks were to materialise. However, from the EBA's reading of the notification, the measure seems to be addressing a structural issue in the Estonian banking sector (i.e. the significant share of housing loans from IRB banks, the different levels of risk weights on mortgage loans within IRB banks and the differences in risk weights between SA banks and IRB banks) rather than an increase in the intensity of systemic risk, which is the underlying condition for using Article 458. This is especially relevant since the notification points out that while the risk weights on an aggregate level have decreased, the systemic risk level in the country remains unchanged. Nevertheless, further information exchange with the ECB indicated that the robust lending dynamics, real estate price developments and elevated household indebtedness levels for comparable countries, as well as business cycle indicators, point to a gradual increase in systemic risk from residential real estate markets in Estonia and that the proposed macroprudential measure by Eesti Bank is understood in this context.

34. The EBA also notes that the proposal to include a risk-weight floor in Estonia in order to reduce the difference in risk weights between IRB and SA banks (among other objectives) comes ahead of the finalization of the TRIM exercise and few years before the implementation of output floors envisaged under Basel III. For this reason, if the measure were put in place, the EBA would encourage Eesti Pank to closely monitor developments in the property market and reassess the rationale for the measure in the light of the outcome of the TRIM assessment, as well as considering its possible overlap with the output floor.

35. The EBA intends to transmit the present Opinion to the addressees foreseen by law, with the provision that it may revise its assessment if requested by the European Commission.

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

Done at London, 15 May 2019

[signed]

Jose Manuel Campa
Chairperson
For the Board of Supervisors