EBA/Op/2019/07

30 July 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 28 June 2019, the EBA received notification from the Finnish Financial Supervisory Authority (FIN-FSA) of its intention to apply Article 458(9) of the Capital Requirements Regulation (CRR)[1] to extend a measure introduced by the FIN-FSA in 2017 making use of Article 458(2)(d) of that Regulation to modify capital requirements in order to account for changes in the intensity of macroprudential/systemic risk that could pose a threat to financial stability in Finland.

2. The EBA's competence to deliver an opinion is based on Article 34(1) of the EBA Founding Regulation[2] and subparagraph (2) of Article 458(4) of the CRR.

3. Within one month of receiving the notification from the designated or competent authority entrusted with the national application of that provision, 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 (the Commission) and the Member State concerned.

4. In accordance with Article 14(5) of the Rules of Procedure of the EBA, the Board of Supervisors has adopted this opinion.

Background of the measure to be extended

5. The measure consists of the extension of a credit institution-specific minimum level of 15% for the average risk weight on residential mortgage loans applicable to credit institutions that have

[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).

adopted the internal ratings-based (IRB) approach. The period of application of the extension will be from 1 January 2020 until 31 December 2020.

6. The original measure was notified to the EBA on 27 June 2017 and the EBA submitted its Opinion[3] to the Council, the Commission and the Member State on 27 July 2017. This measure came into force on 1 January 2018 following the Commission's decision not to object, notified to the FIN-FSA on 21 August 2017.

7. In its Opinion of 27 July 2017, the EBA did not object to the adoption of this measure, taking into consideration that this could be seen as increasing the resilience of the Finnish banking sector.

8. The EBA acknowledged the macroprudential risks in the Finnish economy related to residential mortgage loans and residential mortgage indebtedness, also based on the 2016 Warning of the European Systemic Risk Board (ESRB) in the real estate market in Finland.[4] In addition, the Board of Supervisors had not identified any concerns with the proposed measure or likely negative consequences.

9. However, the EBA raised some issues in its Opinion, including the following:

   - A review of internal models based on Articles 101 and 102 of the Capital Requirements Directive (CRD)[5] could have been an effective measure to increase risk weights, which were considered too low to cover a severe risk scenario like the 1990s banking crisis in Finland. This view was also supported by the fact that, although there was no clear evidence of differences between risks in credit institutions' residential mortgage loan exposures, the risk weights were heterogeneous between Finnish banking groups.

   - As the notification stated that the measure was implemented mainly to address structural risks, a risk weight add-on could be more effective than a risk weight floor. The introduction of a risk weight floor entails that the measure has no or only a small impact for those credit institutions close to or above the floor.

   - In addition, such structural risks could have been addressed with the same impact on credit institutions by setting an institution-specific systemic risk buffer (SRB), which could have been more efficient than the proposed measure, as well as fully transparent. The setting of an SRB would also have avoided any potential overlaps with Pillar 2 capital requirements or Pillar 2 guidance based on a stress test involving residential mortgage exposures as well as related Pillar 2 requirements, for example for concentration risks.

Opinion on the extension

[3] EBA/Op/2017/10.

[4] https://www.esrb.europa.eu/pub/pdf/warnings/2016/161128_ESRB_FI_cover_letter.en.pdf?df3781b949ecff6bc735d8

[5] 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.

Economic rationale for the measure

10. Since the intensity of macroprudential/systemic risk in the financial system with the potential to have serious negative consequences for the financial system and the real economy in Finland remains elevated, the FIN-FSA has decided to extend the period of application of its earlier decision of 26 June 2017 for one year until 31 December 2020.

11. Most of the factors affecting the changes in the intensity of macroprudential/systemic risk underlying the measure are unchanged from those observed in the original measure, such as a persistent structurally high level of debt-to-income ratio (127.3% at end-2018); the majority (more than 97%) of residential mortgage loans being tied to variable interest rates; and an increase in house prices over the long term, especially when looking at the risk of regional price overvaluation (especially in the Helsinki area).

12. The FIN-FSA believes that the reasons why these elevated systemic risks may pose a threat to the financial stability in Finland continue, by and large, to be the same as they were two years ago when the initial decision on the introduction of the risk weight floor was made. Specifically, both Finnish banks and households are highly exposed to housing market risks, with a large proportion of loan stock consisting of housing loans and housing company loans.

13. Systemic risks and vulnerabilities related to housing loans and household indebtedness in Finland are also acknowledged by a number of international institutions, such as the European Central Bank (ECB), the ESRB (as mentioned above), the Organisation for Economic Co-operation and Development and the International Monetary Fund.

14. In addition, it is pointed out in the new notification that Nordea's redomiciliation in 2018 further increased the Finnish banking sector's size, degree of concentration and interconnectedness with the rest of the Nordic banking system. Furthermore, reflecting the transfer of Nordea's domicile, the credit institutions sector's dependence on market funding grew further in late 2018.

15. The FIN-FSA also states that, according to international comparisons, the average risk weights of Finnish banks are still among the lowest in the EU (the weighted average of the relevant risk weights of a representative group of IRB banks was 9.55% at the end of 2017, and 10.09% at the end of 2018). For this reason, if the risk weight floor set by the original national measure were repealed, the FIN-FSA believes that there would still be a clear negative impact on the banks' risk weights.

16. The main feature of the measure and its calibration remain unchanged with respect to the original measure. In particular, the FIN-FSA writes that the measure applies an average risk weight floor rather than an add-on because an average is seen as less intrusive in terms of effects on credit pricing and risk-based allocation of credit to the real economy. The average risk weight floor was also motivated by the fact that the risk profiles of the housing loan stocks of individual credit institutions were rather similar and the floor provided a more uniform back-stop when allocating capital in order to cover for the inherent risks in mortgages.

17. Whereas the FIN-FSA had estimated the impact of the measure on the capital requirement for Finnish credit institutions to be approximately EUR 450 million (based on Q4 2016 data), the impact on the materialised minimum total capital requirement including all buffers due to the national measure taken was EUR 700 million as of Q1 2019. Taking into account the two bank-specific risk weight floors introduced by the ECB as microprudential supervisor, the impact was EUR 200 million. The impact on the overall Common Equity Tier 1 ratio of the representative banks that were affected by the risk weight floor was 0.4% as of Q1 2019, and taking into account the ECB floors this was reduced to 0.1%.

18. According to the residential property valuation indicators calculated by the ECB and national indicators calculated by the Bank of Finland, there is no clear evidence of a general overvaluation in the Finnish housing market. The main purpose of the measure would still be to target potential asset bubbles in the residential real estate sector by strengthening the resilience of the banking sector as part of the financial system.

19. The FIN-FSA Board will reassess the need for an average minimum risk weight for housing loans once CRD V/CRR II amendments enter into force in 2021. The amendments will enable the use of a sectoral SRB applicable to retail exposures to natural persons that are secured by residential property (Article 133(5)(b)(i) of CRD V). The FIN-FSA will take into account the capitalisation of the credit institution sector and the existence of other measures restraining the effect of the minimum risk weight floor as well as the development of the level of household indebtedness in Finland and borrower-based instruments available.

Rationale for not using alternative measures

20. The present notification reiterates the previous justifications for the choice to deploy Article 458 of the CRR:

- Article 124 of the CRR does not apply to credit institutions using the IRB approach.
- Increasing the loss given default (LGD) floor for mortgage loans as per Article 164 of the CRR would not be applicable, as the need for an increase in the mortgage risk weights is not related to low LGD values. In addition, the FIN-FSA writes that the increase in the LGD floor would widen the differences in risk weights between institutions and result in a (disproportionate) increase in risk weights for some credit institutions.[6]
- Articles 101 and 102 of the CRD would not be applicable, as existing models are based on valid statistical microprudential data but do not take into account the additional systemic risk and the second-round effects deriving from an overall high level of mortgage lending

[6] The FIN-FSA writes that the IRB risk weight formula is a linear function of the LGD parameter. Thus, an increase in the LGD, ceteris paribus, would multiply all the current risk weights by the same factor. Because of this linearity, the higher the initial risk weight of a loan is, the higher is the absolute increase in the risk weight resulting from the increase in the LGD. An increase in the LGD floor has a similar linear (or close to linear) unwanted impact on average risk weights at a bank level, if banks' initial average LGD levels are close to the current LGD floor of 10%. This is the case with Finland. Thus, looking at a bank level, an increase in the LGD has the biggest absolute impact for banks with the highest initial average risk weights in their housing loan portfolios. With regard to the banks with lowest average risk weights, an increase in the LGD would lead to an unwanted widening of differences in average risk weights between banks.

and house indebtedness. The FIN-FSA also states that where the ECB, as microprudential supervisor, has taken measures for significant credit institutions under its supervision that would limit the impact of the minimum average risk weight applied by the FIN-FSA, and where such measures are still in place, there is uncertainty about if and when these measures taken by the ECB will be removed.

- The application of Articles 103 and 104 of the CRD would not be effective for a number of reasons, including the fact that a large part of the Finnish mortgage market is held by branches of foreign credit institutions headquartered in other Nordic countries, and the need to call for coordination of these requirements among the different authorities involved. The FIN-FSA also adds that forthcoming amendments to the CRD (CRD5/CRR2) will remove the option to use Pillar 2 for macroprudential purposes.

- Regarding Article 133 of the CRD (SRB), the FIN-FSA writes that the SRB was introduced in Finland at the beginning of 2018 and it entered into force on 1 July 2019 as an institution-specific buffer targeting all credit institutions on a 1.0% level and the largest credit institutions on a 1.5-3.0% level. However, applying the buffer on one category of credit institutions – IRB banks – would require legal justifications that appear difficult to identify. In addition, applying the SRB to exposures would not have the same impact as the risk weight floor because the upper limit for the buffer is restricted to 3.0% or, alternatively, 5.0%. Finally, the FIN-FSA finds that the scope of application of the buffer on mortgages pursuant to the current Article 133 of CRD is uncertain, even though it is acknowledged that CRD V/CRR II will introduce the possibility of applying a sectoral SRB applicable to retail exposures to natural persons that are secured by residential property.

- Article 136 of the CRD (countercyclical capital buffer) is a cyclical measure, whereas the macroprudential/systemic risk addressed by the FIN-FSA is structural. In addition, the countercyclical capital buffer applies to the aggregate credit stock, whereas the identified risk concerns real estate mortgages only.

Assessment and conclusions

21. Based on the evidence provided by the FIN-FSA, the EBA acknowledges the enduring macroprudential risks in the Finnish economy related to residential mortgage loans and residential mortgage indebtedness and it does not object to the deployment of macroprudential measures.

22. However, the concerns raised to the Commission in the EBA Opinion of 27 July 2017 regarding the choice of measure, the calibration of the measure and the impact of the measure raised remain valid.

23. In particular, even though the EBA acknowledged in 2017 that an IRB model review would take time and resources, and would not be effective in the short term, it is noted that a review could have been carried out in the past two years after the application of the original measure. Nevertheless, as the FIN-FSA reiterates its concern that observed risk weights in Finnish banks

are heterogeneous, even though there is no evidence of clear differences between risks in banks' housing loan exposures, a Pillar 1 model review may still be warranted. The FIN-FSA mentions that the ECB, as microprudential supervisor, has taken measures for significant credit institutions under its supervision in the form of risk weight floors, but the notification does not describe the basis of or the rationale behind these measures. The EBA acknowledges that the information on (measures taken for) individual banks cannot be disclosed by the ECB. Nevertheless, it is unclear to the EBA how the two different floors (one macroprudential, applied to all banks, and the second microprudential and bank-specific in nature, applied to only two banks) would coexist and interact for Finnish banks.

24. A SRB was imposed on all credit institutions in Finland in 2018. The EBA acknowledges the limitations (coming from the current application of CRD IV and Finnish law) listed by the FIN-FSA on the use of this buffer to address the identified macroprudential concern, but notes that the proposal to include a risk-weight floor in Finland comes a few years before the entry into force of CRD5/CRR2 amendments on the use of a sectoral SRB. For this reason, and also taking into consideration the future implementation of output floors envisaged under Basel III, the EBA would encourage the FIN-FSA to closely monitor developments in the property market and reassess the rationale for the measure in the light of the outcome changes in the regulation and possible overlap with the output floor.

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

Done at Paris, 26 July 2019

Jose Manuel Campa

Chairperson
For the Board of Supervisors