



EBA/Op/2016/03

19 February 2016

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

Introduction and legal basis

1. On 21 January 2016 the EBA received a notification from the National Bank of Belgium (NBB) of its intention to apply Article 458(9) of Regulation (EU) No 575/2013 of the European Parliament and of the Council¹ to extend a measure introduced by the NBB in 2014 making use of Article 458(2)(d) of that Regulation to modify capital requirements in order to account for an increase in macroprudential or systemic risk that could have a severe impact on the financial system and the Belgian real economy.
2. 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 Council² and Article 458(4) of Regulation (EU) No 575/2013. Article 458 of Regulation (EU) No 575/2013 requires designated or Competent Authorities entrusted with the national application of that provision to notify the EBA where the authority identifies changes in the intensity of macroprudential or systemic risk in the financial system with the potential to have serious negative consequences to the financial system and the real economy in a specific Member State and which that authority considers would better be addressed by means of stricter national measures. Within one month of receiving the notification the EBA is required to provide its opinion on the points in Article 458(2) of that Regulation to the Council, the Commission and the Member State concerned.

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)

3. The notification follows a consultation between the NBB and the EBA in accordance with Article 458(9) of Regulation (EU) No 575/2013.
4. In accordance with Article 14(5) of the Rules of procedure of the EBA, the Board of Supervisors has adopted this Opinion.

Background on the measure to be extended

5. The notification of NBB pertains to the extension of an increase of risk weights for retail exposures secured by Belgian residential immovable property for Belgian Internal Ratings Based (IRB) banks by an add-on of five percentage points.
6. The original measure had been notified to the EBA on 01 April 2014 and was introduced following a European Commission's decision not to object notified to the NBB on 28 May 2014. The EBA had submitted its opinion³ to the Council, the Commission and the Member State on 30 April 2014.
7. In its Opinion of 30 April 2014 the EBA did not object the adoption of these measures, taking into consideration that those could be seen as increasing the resilience of the Belgian banking sector and that such a measure had already been introduced in 2013 without any sign of negative impact on the internal market. The EBA acknowledged that an additional capital requirement was justified by the potential overvaluation of the Belgian real estate market. In addition, the Board of Supervisors and the relevant supervisory colleges had not identified any concerns with the proposed measure or likely negative consequences.
8. However, the EBA raised two issues in its opinion:
 - Information provided in the notification as of 01 April 2014 and data analysed by the EBA indicated that the level of risk varied from credit institution to credit institution and that risk weights were relatively low due to low LGD values. The dispersion across credit institutions suggested that the issue of low risk weights could be addressed using institution-specific (microprudential) instruments as also mentioned by the NBB. The EBA, therefore, agreed with the NBB that an evaluation of the adequacy of IRB models applied by credit institutions should be carried out in accordance with Article 101 of Directive 2013/36/EU with a focus on downturn LGDs. The EBA also acknowledged that the re-assessment of internal models could take time and might not be sufficient to fully address the macroprudential purpose. In any case, the conclusion of this evaluation should be taken into account when reviewing the measure.

³ EBA OP-2014-02

- The EBA also stated the view that, given the variance of credit institutions' risk profiles this could also be addressed with institution-specific supervisory measures in accordance with Articles 103 and 104 of Directive 2013/36/EU and that this could limit potential distortions caused by a constant add-on to risk weights that could penalize banks with more conservative credit standards or models.

Opinion on the extension

Economic rationale for the measure

9. According to the notification submitted by the NBB, the initial implementation of the measure aimed primarily at enhancing the resilience of the Belgian banks against potential credit losses in the event of a downturn of the residential real estate market. During these last two years, the NBB has continued to monitor the evolution of the residential real estate market and risk profile of banks' mortgage portfolio.
10. While lately the real estate market has somewhat stabilised, also with the tightening of credit standards, the NBB believes that there are still risks related to the housing market in Belgium and this would justify the extension of the existing measure. In particular, the NBB mentions the fact that the decline in real estate prices remains a risk. Furthermore, the overall risk profile and quality of the residential mortgage portfolios of the main credit institutions remain unchanged, and household indebtedness has continued to rise.
11. The NBB notes that the nominal property prices have more than doubled in Belgium since the beginning of the century, without experiencing any sharp corrections. In fact, compared to other euro area countries, Belgian nominal property prices suffered smaller and less persistent correction in the aftermath of the financial crisis. While the growth rate of nominal real estate prices has declined markedly since 2011, preliminary figures for 2015 point to a pick-up accompanied with an increase in average prices. According to the estimates provided by NBB based on the preliminary 2015 data, the significant reduction of the tax deductibility for new mortgage loans as from 1 January 2015 in Flanders did not lead to a downward correction in house prices, pushing the modelled estimate of the overvaluation of house prices up from around 0 % to around 8 %.
12. The NBB emphasises that this dynamics could determine credit losses on banks' mortgage portfolios in light of a series of vulnerabilities and namely: recent acceleration of credit growth as the result of low interest rates as well as tax relief in some areas; the gradual increase in mortgage debt to GDP (59% in the third quarter of 2015 from 39.2% in 2000); the high loan-to-value ratios for an important share of the flow of new loans (44,3% with LTVs > 80%).

Rationale for not using alternative measures

13. Regulation (EU) No 575/2013 and Directive 2013/36/EU offer various different options for addressing banks' vulnerabilities and Article 458 (2) (c) of Regulation (EU) No 575/2013 requires the designated authority to justify why the stricter national measure is necessary and other possible measures (i.e. Articles 124 and 164 of the same Regulation and Articles 101, 103, 104, 105, 133, and 136 of Directive 2013/36/EU) cannot adequately address the macroprudential or systemic risk identified, taking into account the relative effectiveness of those measures.

14. The notification provides a comprehensive justification of the NBB decision to deploy Article 458 of Regulation (EU) No 575/2013. In particular, they claim that:

- Article 124 of Regulation (EU) No 575/2013 would not be adequate since it enables the Competent Authority to increase the risk weight of mortgage loans in the standardised approach, while banks using internal models for the exposures towards the residential real estate represent about 90% of the market shares. For the institutions using the standardised approach the 35% risk weight is considered to be sufficient by NBB.
- Increasing the Loss Given Default (LGD) floor for mortgage loans as per Article 164 of Regulation (EU) No 575/2013 would not have impact for banks that use less conservative credit standards, as opposed to those that use more conservative standards and show the lowest risk weight. Indeed, according to the NBB, the relative magnitude of the risk weights produced by banks' internal models is consistent with their respective portfolios' risk profiles. Consequently, the NBB considers that it is more adequate to require each bank to increase its risk weights than to raise the LGD floor.
- As for Articles 102, 103 and 104 of Directive 2013/36/EU, the NBB lists a series of arguments against their use in this specific case. First of all, the proposed measure is to be applied to all banks applying internal models and it is not based on the risk assessment made pursuant to Article 97 of Directive 2013/36/EU on an individual basis. The main rationale is rather macroeconomic concerns relating to the potential evolution of the residential properties in Belgium. In addition, under the Regulation N° 1024/2013, the NBB is not the Competent Authority anymore for the Belgian banks using an internal model and could not deploy measures under Articles 103 and 104 of Directive 2013/36/EU. The NBB also notes that the use of Articles 103 and 104 is less transparent as Pillar 2 measures are currently not publicly disclosed. Moreover, increasing risk weights under Pillar 1 leads to a lower banks' reported capital adequacy ratio and thus better highlight their lower capacity to absorb unexpected losses. There is additionally a point regarding the scope of the measure since while the risk weight add-on applies to both the outstanding stock of mortgages and the flow of new loans, a Pillar 2 capital requirement would only apply to the outstanding stock, also considering that Pillar 2 decision are taken once a year. The NBB also claims that applying the measure under Pillar 1 would produce

a sort of magnifying effect since any other macro-prudential capital buffers would be affected by the higher risk-weights.

- NBB notes that Articles 101 and 102 of Directive 2013/36/EU would not be applicable as the banks using IRB models comply with all the requirements of the Regulation N° 575/2013 and there is no evidence of a breach of this Regulation. A review of internal models carried out by the NBB has not revealed generalised problems related to the outcomes of internal models, confirming that the low risk weights are simply the result of data not incorporating any major property crisis in Belgium. On the other hand, idiosyncratic weaknesses have been addressed and some banks were asked to strengthen their internal models.
- As per Article 133 of Directive 2013/36/EU, the NBB notes that the increase of the risk weight for residential mortgage loans is proposed to limit the risk of a potential cyclical downturn in the residential real estate market and not structural risks as the systemic risk buffer would do. In addition, the systemic risk buffer cannot be applied to specific asset classes. Similarly, the countercyclical buffer as per Article 136 of Directive 2013/36/EU applies to all exposures located in a jurisdiction and, thus, would not achieve the objective of the proposed measure.

Assessment and conclusions

15. The measure proposed for extension includes an increase of risk weights for retail exposures secured by residential immovable property for Belgian IRB banks by an add-on of five percentage points and therefore addresses vulnerabilities in the residential property sectors as envisaged in Article 458 (2) of Regulation (EU) No 575/2013. The main argument given in the notification is that – while developments in the Belgium property market (particularly the increase in real estate prices along with high LTV levels and rising indebtedness of the household sector) continue to be a source of concern – risk weights for exposures towards residential mortgages may not sufficiently reflect credit losses that may occur in the envisaged scenario. This seems the result of lack of data on property crisis for Belgium, which makes it impossible for IRB banks to estimate conservative risk parameters.

16. The EBA acknowledges that the increase in house prices and debt levels in combination can pose a threat to financial stability for banks in Belgium and does not object the deployment of macroprudential measures. In addition, based on the feedback received from the other EU Competent Authorities, the potential of the proposed measure to have a negative impact on the Single Market seems limited. As a matter of fact, De Nederlandsche Bank (DNB) decided to reciprocate the measure for Dutch banks. However, there are some issues raised in the EBA Opinion of 30 April 2014 that remain valid:

- In the annex to its notification the NBB states that the Bank evaluated the adequacy of the calibration of the Probability of Default (PD) and LGD models used in the regulatory capital calculation within the IRB approach. On average, no major weaknesses were observed so

that Article 101 of Directive 2013/36/EU would not be applicable, although some recommendations to adapt their Pillar 1 models were issued to some banks which presented some unsatisfactory calibrations. However, the notification implies that risk weights for Belgian IRB institutions are seen as too low. The EBA therefore continues to believe that the issue underlying the macroprudential measure could at least partly and in the longer run be addressed by requiring changes in banks' IRB models.

- The EBA is still of the opinion that an additive adjustment of risk weights as proposed can have a distorting effect, since it would reduce the incentive to estimate conservative risk parameters. Indeed, all banks are subject to the higher risk-weight, regardless of the margin of conservatism already embedded in their models.
- Based on the information provided in the notification it is unclear how a five percentage points increase is proportionate to the risk for financial stability. While the calibration has been based on past stress tests, the appropriateness of this level in light of a potential worsening of conditions in the Belgium housing market could be further assessed based on stress tests as part of the Supervisory Review and Evaluation Process (SREP). This would also allow to calibrate the add-on bank by bank and, possibly, address this in a more risk-sensitive and idiosyncratic fashion.

17. On the possible use of Pillar 2 as an alternative measure, the EBA takes note of the governance constraints mentioned by the NBB, but it also underlines that the assessment of the most suitable tool to be deployed for addressing risks to financial stability has to be independent of the institutional setup within the Single Supervisory Mechanism (SSM). The assessment by the EBA as required by Article 458(4) of Regulation (EU) No 575/2013 can solely be based on the points mentioned in paragraph (2) of that Article. The fact that it is the European Central Bank (ECB) (and not the NBB) that, as Competent Authority could apply microprudential measures therefore has no impact on the assessment. In addition, Articles 5 of Regulation 1024/2013 (SSM Regulation) and 101 to 105 of Regulation 468/2014 (SSM Framework Regulation) provide for the appropriate framework of cooperation between Competent and Designated Authorities for macro-prudential measures.

18. In addition, Article 103 (1) of Directive 2013/36/EU (specifies that the SREP can be applied in a similar or identical manner to institutions with similar risk profiles. The NBB argues that the proposed measure is not based on the supervisory review process but on concerns regarding the banking sector as a whole. It also argues that measures under Article 104 Directive 2013/36/EU (Pillar 2 measure) would be less transparent since not publicly announced. The potential benefits of Pillar 2 measures would have to be weighed against their potential downsides in terms of transparency and difficulties to reciprocate. In that respect, it is useful to recall that the EBA Opinion on the interaction of Pillar 1, Pillar 2 and combined buffer requirements and restrictions on distributions (EBA/Op/2015/24, 16 December 2015) underlines that “for the purposes of the most effective and transparent application of Article 141 of the CRD on the MDA, it is imperative that the appropriate degree of disclosure of the

institutions' own funds requirements is achieved" and promotes the disclosure of Pillar 2 requirements in this context.

19. The EBA agrees with the NBB that cyclical risks should be addressed with countercyclical and temporary measures as opposed to more structural measures such as the systemic risk buffer. Given the cyclical and portfolio-specific nature of the proposed measure, as argued by the NBB, it is of utmost importance that the NBB continues monitoring the developments in the property market and re-assess the rationale of such measure over time.

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

Done at London, 19 February 2016

[signed]

Andrea Enria

Chairperson

For the Board of Supervisors