EBA/Op/2020/16

16 October 2020

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

Introduction and legal basis

1. On 16 September 2020, the EBA received notification from Finansinspektionen, the Swedish Financial Supervisory Authority, of its intention to apply Article 458(9) of Regulation (EU) No 575/2013 of the European Parliament and of the Council (the Capital Requirements Regulation – CRR).[1] This notification concerned the extension of a measure introduced by Finansinspektionen in 2018, making use of Article 458(2)(d)(vi) of that Regulation, intended to mitigate changes in the intensity of risk that could pose a threat to financial stability in Sweden and concerning risk weights to target asset bubbles in the residential property and commercial immovable property sectors.

2. The EBA's authority to deliver an opinion is based on the second subparagraph of Article 458(4) in conjunction with Article 458(9) of the CRR.

3. According to the second subparagraph of Article 458(4) of the CRR, within 1 month of receiving a 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.

4. In accordance with Article 14(5) 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 to the measure to be extended

5. Finansinspektionen's intention is to extend the current measure under Article 458 of the CRR. The measure is a credit institution-specific minimum level of 25% for the average risk weight on Swedish housing loans applicable to credit institutions that have adopted an internal ratings-based (IRB) approach. The period of application of the extension will be from 31 December 2020 until 30 December 2021.

6. The original measure was notified to the EBA on 24 May 2018 and the EBA submitted its opinion[3] to the Council, the Commission and the Member State on 25 June 2018. This measure came into force on 31 December 2018 following the Commission's decision not to object, notified to Finansinspektionen on 17 July 2018.

7. The EBA did not object to the adoption of this measure. The EBA acknowledged the macroprudential risks in the Swedish economy related to residential mortgage loans and households' indebtedness.

8. However, the EBA raised some issues in its opinion, including the following.

   - A review of internal models based on Articles 101 and 102 of Directive 2013/36/EU (the Capital Requirements Directive – CRD)[4] could have been an effective measure to increase risk weights, which were considered too low to take into account the potential credit losses on Swedish mortgages in a severe downturn scenario.

   - The decision to use Article 458 of the CRR was driven by the decision of Nordea to move its legal domicile from Sweden; the EBA was of the opinion that a reasoning based on changes in governance could not be considered adequate justification for a change in the regulatory framework. In addition, the notification included several references to the fact that, once Nordea's move was finalised, the supervisory practice of the Single Supervisory Mechanism/European Central Bank would make it highly unlikely that the same floor would be applied under Pillar 2 to Nordea. The EBA, in its opinion, deemed it inappropriate to preempt future supervisory decisions of any other authority on reciprocity.

   - The measure was calibrated to keep capital requirements unchanged in absolute terms between the former Pillar 2 measure and the new Article 458 measure, and the EBA noted that the notification did not mention the underlying rationale for keeping the same floor level under Pillar 1. In this respect, the EBA saw a need to carry out further specific analysis, as part of the close monitoring of the appropriateness of the proposed measure, of the risks surrounding the Swedish mortgage and residential real estate markets.

[3] https://eba.europa.eu/eba-does-not-object-to-the-swedish-fsa-proposed-measures-to-address-macroprudential-risk

[4] 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 (OJ L 176, 27.6.2013, p. 338).

Opinion on the extension

Economic rationale for the measure

9. Finansinspektionen has decided to extend the period of application of its earlier decision by 1 year, from 31 December 2020, as the intensity of macroprudential risk in Sweden is persistent.

10. Most of the vulnerabilities affecting the changes in the intensity of macroprudential risk or systemic risk are unchanged from those observed when the original measure was notified. According to Finansinspektionen, the substantial level of systemic risk related to the housing market and the persistence of macrofinancial vulnerabilities in Sweden are mainly linked to:

    - the protracted expansion of banks' exposures to mortgage lending to Swedish households;
    - persistent signs of some overvaluation in housing prices;
    - the persistence of households' indebtedness, supported by dynamic growth in mortgages;
    - the majority of residential mortgage loans (60% in March 2020) being tied to variable interest rates;
    - competition from new financial actors on the mortgage loan market resulting in a greater supply of mortgages at cheaper interest rates and potentially further increasing household indebtedness, thus intensifying systemic risk.

11. Swedish mortgages constitute an important and large proportion of the balance sheet of Swedish banks, which continues to grow (at an annual growth rate of 5.3% in March 2020). Consequently, Finansinspektionen argues that, in the event of a severe downturn in the Swedish economy or turbulence in the financial system, a negative dynamic may arise between the residential real estate market, the macroeconomic situation and bank behaviour in Sweden. This could have negative repercussions for the Swedish real economy and in the long run pose a threat to the stability of the banking system. Moreover, Finansinspektionen points out that Swedish banks have close links with other countries in the Nordic and Baltic regions, suggesting that safeguarding financial stability in Sweden could have positive effects on financial stability in the Nordic and Baltic regions.

12. The calibration of the measure remains unchanged with respect to the original measure. Finansinspektionen has assessed that this calibration is set so that the minimum level for the average risk weight floor both securely covers future losses on Swedish residential mortgages in a severe downturn scenario with high financial stress and takes into account the broader systemic risks that could arise from spillovers. A risk weight floor of 25% is considered to continue to be adequate for this purpose, as the underlying risks have not materially changed since 2018.

13. Finansinspektionen estimates that the capital requirement, in nominal terms, corresponding to a 25% risk weight floor for Swedish mortgages is SEK 94 billion at the consolidated level (data from Q2 2020), or just under 22% of the total capital requirement for the nine largest Swedish

banks[5] (compared with SEK 111 billion at the time of the original notification in 2018 or 15% of the total capital requirement for the largest IRB banks). The measure increases the implied risk weights on Swedish mortgage exposures from 4.5% on average (volume-weighted) to 25%. Thus, the risk weight floor has increased capital levels and created additional loss-absorbing capacity in the Swedish banks targeted by the measure.

14. Finansinspektionen considers that the proposed measure is necessary, suitable, effective and proportionate on the basis of a number of considerations. First, the proposed measure is intended to ensure that important residential mortgage banks are fully resilient and can withstand a potentially severe downturn in the housing market without restricting the supply of credit. Second, the measure is effective and proportionate in that it targets those specific exposures that give rise to the risks identified linked to Swedish mortgages and residential real estate. The design of the measure is such that it targets the mortgage exposures of IRB banks without spilling over to other parts of the banks' lending. Third, the measure is suitable and effective, as it is intended to ensure a level playing field for all banks that operate in the Swedish residential mortgage market while also ensuring resilience and safeguarding financial stability. Furthermore, the measure ensures that capital levels are upheld and contributes to mitigating the risks highlighted in the European Systemic Risk Board's warning of November 2016[6] and recommendation of June 2019.[7]

Rationale for not using alternative measures

15. The CRR and the CRD offer various options for addressing macroprudential risks. Article 458(2)(c) and (e) of the CRR requires 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 CRR and Articles 101, 103–105, 133 and 136 of the CRD) cannot adequately address the macroprudential and systemic risks identified, taking into account the relative effectiveness of those measures.

17. The present notification reiterates the previous justifications for deploying 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 adequately and effectively address the identified systemic risk if this measure were applied instead of the proposed approach. According to Finansinspektionen, this is because increasing the LGD floor for mortgages would widen the differences in risk weights

[5] Please note that both of these figures are affected by Sweden's release of the countercyclical buffer in March 2020 in response to COVID-19.

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

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

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 probabilities of default (PDs). In addition, 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 affect the calculation of expected loss amounts under Articles 158 and 159 of the CRR. Finally, Finansinspektionen writes that using Article 164 would increase the complexity of determining capital requirements and could reduce the transparency of IRB risk weights for market participants.

- Article 101 of the CRD is not applicable, as Swedish banks using IRB models are not in breach of the CRR's requirements when modelling their Swedish mortgage portfolios. Finansinspektionen states that IRB models are developed using long time series of internal historical data on Swedish mortgage portfolios, which reflect the extremely low credit losses from Swedish mortgages that banks have experienced since the financial crisis at the beginning of the 1990s. In response to the low risk weights of Swedish mortgages, Finansinspektionen continues to perform 'bottom-up repair' measures to enable a review of IRB models for Swedish mortgages.

- Regarding Article 133 of the CRD, on the systemic risk buffer (SyRB), Finansinspektionen writes that it already applies an SyRB of 3% to the three major banks, which addresses the structural risks associated with the large, concentrated and interconnected banking sector in Sweden. Nevertheless, as the Article 458 measure is proposed in response to the elevated and increasing cyclical risks in the residential real estate market – whereas the SyRB's objectives are preventing and mitigating long-term, non-cyclical systemic or macroprudential risk not covered by the CRR – Finansinspektionen believes that Article 133 would not address the risks identified adequately, effectively or proportionately if it were to be used instead of Article 458 of the CRR.

- Regarding Article 136 of the CRD, the countercyclical capital buffer does not specifically target risk in real estate markets and would not be appropriate.

- The focus of Article 105 of the CRD is on specific liquidity requirements, which are not relevant for the purposes of addressing the risks identified and are therefore outside the scope of the assessment.

16. Moreover, the notification includes the following justifications.

- Article 103 of the CRD is not relevant for addressing the risks identified, since two significant lenders in the market are not under Swedish supervisory responsibility (branches of foreign credit institutions headquartered in other Nordic countries), and this tool is predominately microprudential in nature, as is Article 104, making them unsuitable for addressing a macroprudential risk. Furthermore, these measures are more challenging to reciprocate than the proposed measure, and macroprudential use of Pillar 2 measures will not be permitted under CRR2/CRDV.

Assessment and conclusions

17. Based on the evidence provided by Finansinspektionen and on a recent analysis conducted by the European Systemic Risk Board,[8] the EBA acknowledges the sustained high level of systemic risk related to the housing market and the persistence of macroprudential vulnerabilities in the Swedish financial system. The EBA does not object to the 1-year extension of the current measure.

18. In the light of the current circumstances and the COVID-19 pandemic, the EBA would like to provide some additional observations.

- The COVID-19 pandemic may have material implications for the systemic risk related to the housing market in Sweden. However, it is probably too early to assess the impact of the current crisis and the EBA acknowledges the high level of uncertainty. Therefore, the EBA invites the Swedish authorities to reassess the current measure as soon as the first effects of the crisis on Swedish households' demand for residential mortgages and also on banks' supply become visible, taking into consideration that, in the current exceptional circumstances, it is important to support the flow of credit to the real economy.

- The design of the risk weight floor includes all retail exposures secured by real estate, both SMEs and non-SMEs. The inclusion of SME exposures secured by real estate can be inferred from the reference to COREP and its rationale could deserve some more explanation. In line with the previous observation, it is important to monitor the impact of this measure on lending to SMEs and intervene in case there are unintended consequences.

19. In addition to these specific concerns, the EBA has other, general observations.

- According to Finansinspektionen, Swedish IRB banks using internal models comply with all requirements of the CRR. However, the implied risk weights for residential mortgage exposures in Sweden, at 4.5%, are seen as still too low. Finansinspektionen argues that this is because IRB model estimates are based on the extremely low historical credit losses from Swedish mortgages and partly reflect the absence of a major crisis in Sweden in recent decades. Finansinspektionen stresses that credit institutions' IRB approaches are unlikely to fully capture the credit loss risk of Swedish mortgages in a severe downturn scenario.

- In this regard, it should be noted that Articles 101 and 102 of the CRD are meant to address potential deficiencies in the estimation of risk in an institution's internal approach. In particular, the final draft RTS on the assessment methodology for the IRB approach[9] specifies that competent authorities should assess whether the institution has adopted a sufficient

[8] https://www.esrb.europa.eu/pub/pdf/reports/esrb.report190923_vulnerabilities_eea_countries~a4864b42bf.en.pdf

[9] https://eba.europa.eu/regulation-and-policy/credit-risk/regulatory-technical-standards-on-assessment-methodology-for-irb-approach

margin of conservatism, which should account, in particular, for any identified deficiencies in data or methods used in risk quantification and for any increased uncertainty that might result. In particular, PD estimates should be based on a period representative of the likely range of variability of default rates. In practice, the institution may not have sufficient data to encompass the likely range of variability of default rates. In this situation, owing to the increased uncertainty, it may be necessary to adopt a greater margin of conservatism. Moreover, the EBA guidelines on PD estimation, LGD estimation and treatment of defaulted exposures[10] further clarify that, where the historical observation period long-run average 1-year default rate is not representative of the likely range of variability of default rates because there are no or insufficient bad years included in the sample, the average observed 1-year default rate should be adjusted.

- In this regard, the EBA welcomes the ongoing review of IRB models through bottom-up repair measures and acknowledges the time horizon for carrying out such work. Although the EBA has decided to extend the deadline for introducing the changes to the rating systems set out in the IRB roadmap by 1 year,[11] to the end of 2021, the EBA considers that necessary changes resulting from regulatory review should be introduced to all existing models.[12]

- The measure has been in place in one form or another since 2013, originally introduced through Pillar 2 and then replaced in 2018 by the current Article 458 measure. Over recent years, Sweden has experienced a significant and prolonged build-up and intensification of systemic risk related to the housing market and this risk has never been eliminated. Therefore, this measure is becoming permanent rather than temporary, and is being used to fix structural issues in the modelling of IRB models that have remained throughout the years. Consequently, the EBA invites the Swedish authorities to reflect on how these issues could be fixed.

- In addition, the EBA invites Finansinspektionen to reassess the rationale for the measure in the light of the effects of the forthcoming changes to the applicable regulatory framework (in particular, the sectoral SyRB and the output floor).

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

Done at Paris, 16 October 2020

Jose Manuel Campa

[signed]
Chairperson
For the Board of Supervisors

10 https://eba.europa.eu/regulation-and-policy/model-validation/guidelines-on-pd-lgd-estimation-and-treatment-of-defaulted-assets

11 https://eba.europa.eu/eba-publishes-report-on-progress-made-on-its-roadmap-to-repair-irb-models

12 In particular, competent authorities should follow the original implementation plan where feasible, so that the scarce modelling and assessment resources of the institutions and competent authorities are used evenly over the coming months until the end of 2021.