
EBA-Op-2020-04

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

Introduction and legal basis

1. On 27 January 2020, the European Banking Authority (EBA) received 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 Council (Capital Requirements Regulation, CRR)¹ to extend a measure introduced by the NBB in 2018 making use of Article 458(2)(d)(vi) of the CRR to modify capital requirements in order to account for changes in the intensity of macroprudential or systemic risk that could pose a threat to financial stability in Belgium.
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 the 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(2) of the Rules of Procedure of the EBA², the Board of Supervisors has adopted this opinion.

Background of the measure to be extended

5. The measure increases risk weights for internal ratings based (IRB) banks' retail exposures secured by residential immovable property located in Belgium. It consists of two components.

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).

The first component imposes a 5-percentage-point risk weight add-on for IRB banks' exposures to Belgian mortgage loans. The second component further increases the risk weights as a function of the risk profile of the IRB bank's mortgage portfolio by applying a multiplier of 1.33 on the (microprudential) risk weight of the residential mortgage loan portfolio. The extension will be applicable from 1 May 2020 until 30 April 2021.

6. The original measure was notified to the EBA on 22 January 2018 and the EBA submitted its opinion³ to the Council, the Commission and the Member State on 23 February 2018.
7. In its opinion, the EBA did not object to the adoption of this measure. The EBA acknowledged that the increases in house prices and debt levels, in combination, could pose a threat to the financial stability of banks in Belgium in the event of a downturn.
8. However, the EBA raised some issues in its opinion, including the following:
 - The use of a multiplier on the risk weight of the residential mortgage loan portfolio would add further complexity to the determination of capital requirements and could reduce the transparency of risk weights for market participants.
 - The assumption behind the multiplier is that banks' risk weights are an accurate proxy for portfolio riskiness and that the level of conservatism is similar across banks. While this might be true in general, there might be a risk of penalising banks with more conservative internal models and higher starting risk weights. If so, the multiplier may have a distorting effect, since it would reduce the incentive to estimate conservative risk parameters.
 - The use of stress tests to change risk weights can, in certain situations, lead to double-counting of risks, which might or might not be intended by the relevant authority. Moreover, it was not clear if the risks were already covered in capital requirements and Pillar 2 guidance for Belgian banks through stress tests such as the EU-wide stress test.
 - The EBA agreed 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 (SyRB).

Opinion on the extension

Economic rationale for the measure

9. Since the intensity of macroprudential risk in Belgium – with the potential to have serious negative consequences for the Belgian financial system and the real economy – is persistent, the NBB has decided to extend the period of application of its earlier decision of 1 May 2018 for 1 year until 30 April 2021.

³ Opinion of the European Banking Authority on measures in accordance with Article 458 of Regulation (EU) No 575/2013 of 23 February 2018 (EBA/Op/2018/01), available at <https://eba.europa.eu/eba-issues-opinion-on-measures-to-address-macroprudential-ri-3>

10. Most of the vulnerabilities affecting the changes in the intensity of macroprudential risk or systemic risk are unchanged from those observed in the original measure. According to the NBB, the substantial level of systemic risk in banks' mortgage portfolios and the persistence of macrofinancial vulnerabilities in Belgium are mainly related to:

- 1) the protracted expansion of banks' exposures to mortgage lending to Belgian households;
- 2) persistent signs of some overvaluation in housing prices;
- 3) the persistence of household indebtedness supported by excessively loose credit standards; and
- 4) the intense competition between credit institutions on the mortgage loan market and the ensuing loose credit standards and loan pricing.

11. The importance of residential mortgage loan portfolios on the balance sheets of Belgian banks remains significant (around 20% of total assets and 401% of Common Equity Tier 1 (CET1) capital on average) and continues to grow (the average growth in mortgage lending is 5.5%). The NBB argues consequently that a severe downturn in the Belgian residential real estate market may have a substantial impact on institutions' solvency position, which may in turn entail unfavourable consequences for the Belgian real economy. It could also spill over to the commercial real estate market, amplifying the negative shock. Moreover, the NBB points out that safeguarding financial stability in Belgium will have positive effects on financial stability in Europe because of the importance of cross-border banking groups in Belgium and the degree of openness of the Belgium economy.

12. The calibration of the measure remains unchanged with respect to the original measure. The NBB assesses that the severe stress scenario used in the original notification remains meaningful and severe enough to be used to calibrate the measure. An updated sensitivity/scenario analysis indicates that microprudential capital requirements (implied by microprudential risk weights) still remain insufficient to cover all potential losses under severe (macroprudential) stress scenarios and that the macroprudential measure (with the original calibration) is still sufficient to cover – at the level of the sector – the simulated losses.

13. The NBB estimates that the total impact of the proposed measure on IRB banks' CET1 capital is EUR 1.8 billion (compared with EUR 1.5 billion at the time of the original notification in 2018), equivalent to approximately 3.4% of IRB banks' total CET1 capital. The increased impact of the measure on CET1 capital is equivalent to the increased residential real estate exposures of Belgian IRB banks.

14. The NBB assesses that the current measure continues to be necessary, suitable, effective and proportionate. First, the measure strengthens the capital resilience of the Belgian banking sector against a potential severe downturn in the housing market. Second, the measure increases the risk weights (from 9.8 % to 18.1% on average) of portfolios where risk weights are deemed too low compared with the persistent systemic risk in the residential real estate market. Third, the measure complements a recent measure published by the NBB on the supervisory expectations regarding mortgage credit standards. Fourth, the measure provides an incentive-compatible

mechanism for enhancing overall resilience with a multiplier affecting portfolios with riskier profiles more than portfolios with higher credit quality.

15. The NBB argues that the extension also complements other macroprudential instruments in Belgium such as the countercyclical capital buffer (CCyB), which was activated in July 2019 (at 0.5%) and will be binding from July 2020. This measure will increase resilience to overall cyclical systemic risk and help to absorb possible spillovers from residential real estate risks to the non-financial sector or address specific second-round effects in Belgium.

Rationale for not using alternative measures

16. The CRR and Directive 2013/36/EU (the Capital Requirements Directive – CRD)⁴ offer various options for addressing macroprudential risks. Article 458(2)(c) and (e) of the CRR require 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 CRR 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.

17. The present notification reiterates the previous justification for not using alternative measures. Moreover, it includes the following justifications:

- The low level of risk weights applied by Belgian IRB banks does not reflect developments in loss given default (LGD) estimates, which have increased over the last few years, but results from a fall in probability of default (PD) estimates. Therefore, raising the average LGD floor would miss the point and would be a biased way to increase risk weights.
- The option of using Pillar 2 for systemic risk will be removed in the forthcoming applicable national measures transposing the amendments to the CRD introduced by Directive (EU) 2019/878 of the European Parliament and of the Council (CRD V).⁵
- The NBB intends to reassess the need for the current Article 458 CRR measure when the national measures transposing CRD5 become applicable and allow the application of a sectoral systemic risk buffer to retail exposures secured by immovable property for which the collateral (immovable property) is located in Belgium.
- The CCyB has recently been activated in Belgium. This CCyB measure, however, targets the observed acceleration of the Belgian credit cycle (driven mainly by corporate credit) and does not specifically target risk in real estate markets.

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).

⁵ Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures (OJ L 150, 7.6.2019, p. 253).

Assessment and conclusions

18. Based on the evidence provided by the NBB and on a recent analysis conducted by the European Systemic Risk Board,⁶ the EBA acknowledges the sustained high level of systemic risk in Belgian banks' mortgage portfolios and the persistence of macroprudential vulnerabilities in the Belgian financial system. The EBA does not object to the 1-year extension of the current measure.
19. Nevertheless, some of the concerns raised in the EBA opinion of 23 February 2018 to the Commission remain valid.
20. In particular, according to the NBB, Belgian IRB banks using internal models comply with all requirements of the CRR and there is no evidence of any underestimation of risks from a microprudential perspective. However, the resulting risk weights for residential mortgage exposures in Belgium are seen as still too low from a macroprudential point of view. The NBB stresses that the low risk weights implied by these internal models partly reflect the absence of a major crisis in Belgium in recent decades.
21. However, it should be noted that, while Pillar 1 requirements are not intended to cover extreme scenarios, they should be appropriate for a severe economic downturn.⁷ In this regard, Articles 101 and 102, 104 of the CRD are meant to address potential deficiencies in the estimation of risk in an institution's internal approach. Moreover, Article 180(1)(a) of the CRR requires the PD estimation to use long-run averages of 1-year default rates. In the EBA Guidelines on PD estimation, LGD estimation and treatment of defaulted exposures⁸, it is further clarified that the long-run average default rate should be calculated as the average of observed 1-year default rates, if the historical observation period is representative of the likely range of variability of 1-year default rates and, in particular, if the historical observation period contains an appropriate mix of good and bad years.
22. Since the distinction between an extreme scenario and a severe cyclical downturn is not clear-cut, there is a potential grey area between the fulfilment of microprudential and macroprudential purposes. However, the EBA invites the competent authority to continue to remind Belgian IRB banks to review their internal models and address any potential deficiencies affecting their resilience in the event of a severe economic downturn. In addition, the EBA welcomes the intention of the NBB to reassess the rationale for the measure in the light of the

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https://www.esrb.europa.eu/pub/pdf/recommendations/esrb.recommendation190923_be_recommandation~2cb5134896.en.pdf

⁷ According to the RTS on the specification of the nature, severity and duration of an economic downturn, the severity of an economic downturn is specified by the set of the most severe observations on the economic factors constituting the nature of an economic downturn, based on historical values of these factors over the last 20 years. In cases where the time span of 20 years is not considered sufficiently severe, institutions are required to use longer time series of the various economic factors (<https://eba.europa.eu/eba-publishes-final-draft-technical-standards-on-the-specification-of-an-economic-downturn>).

⁸ EBA/GL/2017/16 (<https://eba.europa.eu/sites/default/documents/files/documents/10180/2551996/c1eb68d4-a084-486a-9434-70cd9ae43723/Progress%20report%20on%20IRB%20roadmap.pdf>). The roadmap provides the current implementation time plan for these guidelines. In general, institutions are encouraged to engage with their competent authorities at an early stage in order to determine an adequate implementation plan, including the timeline for the supervisory assessment and approval of material model changes, where necessary.

forthcoming outcome of changes in the applicable regulatory framework (in particular, the sectoral SyRB). Nevertheless, that rationale should also include possible overlap with the output floor.

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

Done at Paris, 26 February 2020

[signed]

Jose Manuel Campa

Chairperson

For the Board of Supervisors