EBA-Op-2021-10

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 20 September 2021, the European Banking Authority (EBA) received a notification from the European Systemic Risk Board (ESRB) on the intention of the *Finansinspektionen*, the Swedish Financial Supervisory Authority, to apply Article 458(9) of Regulation (EU) No 575/2013 of the European Parliament and of the Council (Capital Requirements Regulation, CRR)[1]. This notification concerns the extension for a second time of a measure introduced by the Finansinspektionen in 2018 and extended in 2020, 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. In accordance with the second subparagraph of Article 458(4) of the CRR, within one 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 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 of the measure to be extended

5. The proposed measure under Article 458 of the CRR is an extension for the second time of the current measure which entails 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. It thereby includes retail exposures secured by real estate, both SME and non-SME exposures. The period of application of the extension will be from 31 December 2021 until 31 December 2023.

6. In its Opinions dated 25 June 2018[3] and 16 October 2020[4], the EBA did not object to the adoption of the measure and subsequently the first extension of this measure. The EBA acknowledged that the macroprudential risks in the Swedish economy related to residential mortgage loans and households' indebtedness.

7. However, the EBA raised issues in its Opinion dated 16 October 2020, including the following:

- The extension of the measure was notified amidst the unfolding of an unprecedented crisis, the impact of which was expected to significantly damage the real economy in the EU. The EBA encouraged the Swedish authorities to closely monitor the situation during the Covid-19 pandemic and stand ready to deactivate the notified measure.

- The EBA was concerned about low implied risk weights for residential mortgage exposures in Sweden (4.5%). The EBA stressed that Articles 101 and 102 of the Directive 2013/36/EU[5] (Capital Requirements Directives, CRD) are meant to address potential deficiencies in the estimation of risk in an institution's internal approach. The RTS on the specification of the assessment methodology for the IRB approach specifies that competent authorities should assess whether the institution has adopted a sufficient 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.[6]

[3] Opinion of the European Banking Authority on measures in accordance with Article 458 of Regulation (EU) No 575/2013 of 25 June 2018 (EBA/Op/2018/06) available at https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2137845/6b62e4b6-7e8f-41eb-9492-0c270d5eeffc/EBA%20Opinion%20on%20measures%20in%20accordance%20with%20Article%20458%20%28EBA-Op-2018-06%29.pdf?retry=1

[4] Opinion of the European Banking Authority on measures in accordance with Article 458 of Regulation (EU) No 575/2013 of 16 October 2020 (EBA/Op/2020/16) available at https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Opinions/2020/934115/EBA-Op-2020-16%20-%20EBA%20Opinion%20on%20measures%20in%20accordance%20with%20Art%20458%20%28SE%29.pdf

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

[6] EBA Final Draft Regulatory Technical Standards on the specification of the assessment methodology for competent authorities regarding compliance of an institution with the requirements to use the IRB Approach in accordance with Articles 144(2), 173(3) and 180(3)(b) of Regulation (EU) No 575/2013 of 21 July 2016 (EBA/RTS/2016/03) available at https://www.eba.europa.eu/sites/default/documents/files/documents/10180/1525916/e8373cbc-cc4b-4dd9-83b5-93c9657a39f0/Final%20Draft%20RTS%20on%20Assessment%20Methodology%20for%20IRB.pdf?retry=1

- The measure has been in place in one form or another since 2014. It was originally introduced via a Pillar 2 measure and was subsequently replaced in 2018 by the current Article 458 of the CRR measure. It is noted that reliance has been placed upon the Article 458 measure to correct issues in the modelling of IRB models that have remained throughout the years, rather than the structural issues themselves being fixed.

- The EBA invited Finansinspektionen to reassess the rationale for the measure in light of the effects of the forthcoming changes to the applicable regulatory framework (in particular, the sectoral systemic risk buffer and the output floor).

Opinion on the extension

Economic rationale for the measure

8. Finansinspektionen has notified an extension of the period of application of its earlier decision by two years, from 31 December 2021, as the vulnerabilities and systemic risks stemming from Swedish mortgages and the developments in the housing market remain elevated and are intensifying.

9. 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 relating to the housing market and the persistence of macrofinancial vulnerabilities in Sweden are mainly linked to:
    1) the protracted expansion of banks' exposures to mortgage lending to Swedish households;
    2) persistent signs of some overvaluation in housing prices;
    3) the persistence of household indebtedness, supported by dynamic growth in mortgages;
    4) the majority of mortgages (53%) being tied to floating interest rates;
    5) 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.

10. Swedish mortgages constitute an important and large proportion of the balance sheet of Swedish banks which continues to grow (with an annual growth rate of 6.2% in March 2021). 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 banks' 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.

11. The calibration of the measure remains unchanged with respect to the original measure and its calibration after the first extension. 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 still considered to be adequate for this purpose, as the underlying risks have not materially changed since 2018 when the measure was originally calibrated. Despite the Covid-19 pandemic, risk weights have remained relatively stable and so a risk weight floor of 25% is still deemed to be adequate for this purpose.

12. Finansinspektionen estimates that the capital requirement, which in nominal terms corresponds to a 25% risk weight floor for Swedish mortgages, is SEK 96 billion at the consolidated level (data from Q2 2021), or just under 22% of the total capital requirement for the nine largest Swedish banks[7] (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, compared with SEK 94 billion and 22% at the time of the first extension in 2020 respectively). The measure increases the implied risk weights on Swedish mortgage exposures from 4.4% 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.

13. Finansinspektionen considers that the proposed measure is necessary, suitable, effective and proportionate on the basis of a number of considerations. 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. The measure is deemed to be effective and proportionate in that it targets those specific exposures that give rise to the risks linked to Swedish mortgages and residential real estate. The design of the measure is such that it targets the mortgage exposures of IRB banks. The measure is assessed to be 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 upholding resilience and safeguarding financial stability. The measure ensures that capital levels are upheld and contributes to mitigating the risks highlighted in the European Systemic Risk Board's warning in 2016[8] and recommendation of 2019[9]. Studies by the International Monetary Fund[10] in 2019,

[7] Please note that both of these figures are affected by Sweden's reduction to 0% of the countercyclical buffer in March 2020 in response to COVID-19.

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

[9] https://www.esrb.europa.eu/pub/pdf/recommendations/esrb.recommendation190923_se_recommandation~a11003ac8e.en.pdf

[10] https://www.imf.org/en/Publications/CR/Issues/2019/03/26/Sweden-2019-Article-IV-Consultation-PressRelease-Staff-Report-and-Statement-by-the-46709- 2019-Article-IV-Consultation-PressRelease-Staff-Report-and-Statement-by-the-46709

the European Commission[11] in 2020 and the ESRB[12] in 2021 indicate an overvaluation in the Swedish residential real estate market.

14. Finansinspektionen does not expect the measure to have a negative impact on the internal market. All significant lenders with IRB exposures to the Swedish mortgage market are consolidated in Sweden, except for the Swedish branches of Danske Bank and Nordea Bank, and authorities in the relevant Member States already reciprocate the current measure. Finansinspektionen emphasises that a Memorandum of Understanding (MoU) on prudential supervision of significant branches applies to the Nordic-Baltic macroprudential network[13]. Further, an additional MoU on cooperation and coordination on cross-border financial stability was signed in 2018 by the ministries of finance, financial supervisory authorities, central banks, and resolution authorities of the Nordic Baltic countries[14]. Finansinspektionen assesses that the continued presence of the measure will have a positive impact on the Internal Market as it will bring benefits to financial stability to the region by reducing and mitigating the macroprudential or systemic risk identified.

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 cannot adequately address the macroprudential and systemic risks identified, taking into account the relative effectiveness of those measures.

16. The present notification reiterates the previous justifications for deploying Article 458 of the CRR, and that the measure under Article 458 of the CRR is most appropriate for Finansinspektionen at this time.

- 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, according to Finansinspektionen, serve to widen the differences in risk weights between IRB banks and result in a disproportionate increase in risk weights for some banks. Finansinspektionen stressed that using Article 164 would increase the complexity of

[11] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52020SC0526&from=EN

[12] https://www.esrb.europa.eu/pub/pdf/dashboard/esrb.risk_dashboard210406%7E8f2090e35d.en.pdf?9c4e43ab79a1581de7db104d9904bddb

[13] Memorandum of Understanding BETWEEN FINANSINSPEKTIONEN (SWEDEN), FINANSTILSYNET (NORWAY), FINANSTILSYNET (DENMARK), FINANSSIVALVONTA (FINLAND) and the EUROPEAN CENTRAL BANK on prudential supervision of significant branches in Sweden, Norway, Denmark and Finland of 2 December 201 available at https://www.fi.se/contentassets/dbde31519a7543a18808d3db1deacb4e/mou-filialer-nordiska-lander-2016-12-19n.pdf

[14] Memorandum of Understanding on Cooperation and Coordination on cross-border financial stability between relevant Ministries, Central Banks, Financial Supervisory Authorities and Resolution Authorities of Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden of 31 January 2018 available at https://www.fi.se/contentassets/5529800727444fb0851249b985883373/samforstandsavtal-mou-finansiell-stabilitet-2018-01-31.pdf

determining capital requirements and could reduce the transparency of IRB risk weights for market participants.

- Regarding Article 133 of the CRD, in relation to the systemic risk buffer (SyRB) Finansinspektionen states 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. Finansinspektionen believes that Article 133 would not address the systemic risks identified effectively or appropriately. Finansinspektionen argues that the sectoral application of the SyRB would act as an add-on, and as such would not take into account the differences in risk weights for these exposures and would penalise most the banks with the risk weights closest to the current floor. In order to replace the current floor measure, the applicable buffer rate would have to be set at around 100% for exposures with the lowest risk weight in order to achieve a corresponding capital requirement as a risk weight floor of 25%. In view of this, the size and action of the SyRB's sectoral application would be challenging from both a communication and reciprocity perspective as well as being disproportionate and less effective than the current floor.

- Regarding Article 136 of the CRD, the countercyclical capital buffer (CCyB) is applied to all Swedish credit exposures and not just the mortgage exposures. The Finansinspektionen considers the CCyB not to be appropriate as it would penalise most banks with the lowest share of relevant exposures in mortgage loans.[15]

Assessment and conclusions

17. Based on the evidence provided by Finansinspektionen, the EBA takes note of Finansinspektionen's concerns regarding systemic risk relating to the housing market and the persistence of macroprudential vulnerabilities in the Swedish financial system. The EBA does not object to the 2-year extension of the current measure.

18. The EBA would like to emphasise that this measure has been in place in one form or another since 2014, originally introduced through Pillar 2 and then replaced in 2018 by the current Article 458 measure. The Article 458 measure aims to correct issues in the modelling of IRB models that have remained throughout the years, rather than fixing the structural issues themselves. It appears that the indebtedness and dynamics built up in the Swedish market tend to be permanent and not cyclical. As this concern has been articulated by Finansinspektionen over many years, the EBA strongly encourages Finansinspektionen to undertake a comprehensive and thorough assessment also in respect of the underlying causes and drivers.

19. According to Finansinspektionen, Swedish IRB banks using internal models comply with all the requirements of the CRR. However, the implied risk weights for residential mortgage

[15] The countercyclical buffer rate in Sweden was lowered to zero from 2.5% in 2020 as a measure taken to address the potential impact from the COVID-19 pandemic. The CCyB will be raised again from the current level of zero during the second half of 2021.

exposures in Sweden, at 4.4%, are still much 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 and do not appropriately account for the broader systemic risks that could arise from the Swedish mortgages of individual credit institutions. These persistent low risk weights suggest that a revalidation of the IRB models in Swedish banks may be necessary. 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. The EBA calls on the Swedish authorities to reflect on how these risks could be addressed in the future.

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

21. The EBA also invites Finansinspektionen to reassess the rationale for the measure in light of the currently available (i.e. the sectoral SyRB) and forthcoming (i.e. the output floor[16]) instruments which could be more targeted to or compensate for the risk as it appears to be a structural feature of the Swedish housing market.

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

Done at Paris, 19 October 2021

[signed]

Jose Manuel Campa

Chairperson
For the Board of Supervisors

[16] The output floor has not yet been applicable in Europe, but it is expected to be recommended as a part of the new legislative proposal for CRR3 by the EU Commission.