EBA/Op/2023/06

12 June 2023

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

1. On 12 May 2023, the European Banking Authority (EBA) received a notification from the European Systemic Risk Board (ESRB) on the intention of the Swedish Financial Supervisory Authority (Finansinspektionen), thereafter the 'Swedish FSA', to introduce a new measure in accordance with Article 458 of Regulation (EU) No 575/2013 of the European Parliament and of the Council (Capital Requirements Regulation, CRR)[1].

2. This notification concerns the introduction of a national measure regarding risk weights for targeting asset bubbles in the residential property and commercial immovable property sector (Article 458(2)(d)(iv) of CRR). The proposed measure is a risk weight floor of 35% for certain corporate exposures secured by commercial properties and a risk weight floor of 25% for certain corporate exposures secured by residential properties. The requirement is applicable to credit institutions that use the Internal Ratings Based (IRB) approach for calculating regulatory capital requirements and aims to deal with the systemic risks that are linked to the overheated real estate market in Sweden.

3. The EBA's competence to deliver an opinion is based on the second subparagraph of Article 458(4).

4. In accordance with the second subparagraph of Article 458(4) of the CRR, within one month of receiving 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.

[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 amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

5. In accordance with Article 14(2) of the Rules of Procedure of the EBA[2], the Board of Supervisors has adopted this Opinion.

Background of the measure

6. The proposed measure tackles the elevated systemic risks connected to the real estate sector in Sweden targeting corporate exposures secured both by commercial real estate or residential properties generating rental income (jointly, called hereinafter CRE exposures). According to the Swedish FSA, CRE sector firms are highly indebted and banks' exposures to the sector are large. The measure proposed is applicable to IRB banks as their model-implied risk weights are relatively low to cover the identified systemic risk. The measure thus increases the total risk exposure amount of the affected IRB banks as regard the targeted exposures. It is worth noting that the measure complements the existing measure under Article 458 of the CRR on retail exposures implemented in December 2018, extended twice, the last expiring in December 2023[3], which increases the risk weight for mortgages, and expected to be prolonged, as indicated in the notification.

7. The proposed measure introduces two exposure-weighted floors on average risk weights:

   - 35% for corporate exposures secured by commercial properties;
   - 25% for corporate exposures secured by residential properties.

8. The measure envisages exemptions for the following type of properties: i) agricultural properties, ii) properties owned directly by municipalities, states and regions, iii) properties where more than 50% of the property is used for own business (not rental), iv) multi-dwelling properties where the purpose of the property is not commercial (for example housing associations that are owned by the residents and that are not profit making) or where the number of dwellings is less than four. According to the Swedish FSA, these exemptions target types of real estate associated with a different level of risk compared to other CRE firms because of their ownership or income characteristics.

9. The notification details that the calibration of the risk weights floors is based on several analyses previously conducted by the Swedish FSA. According to the notification, the additional capital requirement ensures that the banks have enough capital to cover the risks in their lending to the commercial real estate sector. The proposed risk weights are differentiated to consider the difference in the financial risks between commercial housing properties (corporate exposures secured by residential real estate) and other commercial real estate. For comparison, the risk

---

[2] Decision of the EBA concerning the Rules of Procedure of the Board of Supervisors of 22 January 2020 (EBA/DC/2020/307).

[3] Opinion of the European Banking Authority of 19 October 2021, on measures in accordance with Article 458 of Regulation (EU) No 575/2013 (EBA-Op-2021-10).

https://www.esrb.europa.eu/pub/pdf/other/esrb.notification20211208_Art.458_SE~b869d4d50e.eng.pdf?f8cdd15dec25f5e8b78850f7fc39ada7 weight floor on retail exposures mortgages in Sweden is also set to 25%, as a national measure according to Article 458 of the CRR referred above.

10. The impact on total capital requirements due to the proposed measure under Article 458 is expected to be limited since the measure will replace a corresponding capital requirement in Pillar 2. In 2020, the Swedish FSA introduced institution specific Pillar 2 requirements for IRB-banks to address the underestimation of risk in the models used for CRE exposures. Currently, banks' internal models are under review and a gradual implementation of new models leads to practical difficulties when using a Pillar 2 capital add-on for the purpose of mitigating these model risks. This add-on is calculated yearly through the comprehensive Supervisory Review and Evaluation Process (SREP) and the Swedish FSA notes that updates to SREP decisions are resource demanding and time consuming. The resilience that the current Pillar 2 measure provides proves to be important for the financial system given the high level of systemic risk related to CRE according to the Swedish FSA. Given the operational complexities of mitigating this risk via a Pillar 2 measure, the notification aims at addressing it through Article 458 as a Pillar 1 requirement. The Swedish FSA sees value in applying Article 458 also because it is straightforward in design when it comes to reciprocity which is important as the risks affect also foreign institutions.

11. According to the information laid out in the notification, the measure increases the average risk weights on Swedish CRE exposures, from 17% (exposure-weighted) to at least 35% for commercial properties and from 13% to at least 25% for residential properties. The capital requirement, in nominal terms, is expected to be SEK 18 billion at the consolidated level (data from Q4 2022) or 4% of the total capital requirement for the largest Swedish IRB banks. The proposed measure is not expected to affect banks' interest margins or the supply of credit to CRE firms because the capital requirements on domestic banks will remain largely unchanged after replacing the Pillar 2 capital requirement measure with the risk weight measure.

12. The introduction of the risk weight floors for corporate exposures secured by CRE and RRE in accordance with Article 458 in CRR is suitable, effective, and proportionate, according to Swedish FSA. Following the elevated systemic risk in the Swedish CRE sector, the measure is necessary to ensure that banks have enough capital to withstand any potential disruptions in the CRE sector that could otherwise affect bank's financial position and the real economy in general. The Swedish FSA intends to request reciprocity by other EU member states. Reciprocity will make sure that the measure also applies to foreign branches and direct foreign exposures. If the measure is reciprocated, the impact on affected banks from other jurisdictions, based on the notification, are presently considered to be small as their current risk weights are higher or close to the proposed floors.

Opinion on the measure

Economic rationale for the measure

13. According to the notification, the Swedish CRE sector is of importance for financial stability because of its size but also because it is well interconnected with both the financial system and the real economy. The Swedish FSA bases its assessment also considering other views such as those expressed by national and international organizations (Riksbank, ESRB and the IMF), which have all highlighted that the CRE sector is one of the biggest vulnerabilities for financial stability in Sweden.

14. The Swedish FSA assesses that Sweden's economic situation, characterised by low interest rates and high economic growth, has benefitted CRE firms which flourished amid low financing costs and good earnings. Along this, property prices increased significantly, which led these firms to borrow more and launch new investment projects. While loan-to-value indicators have been decreasing and remain low (below 50% in 2021), this is mainly attributable to the sharp increase in prices, according to the Swedish FSA. Other indebtedness indicators, such as the interest-bearing liability against net operating income as provided in the notification, show a steep increase from an average ratio slightly above 12 over the observed period starting in 2005 to slightly more than 16 in 2022. This high level of debt makes the CRE sector vulnerable to rising interest rates or a worsened economic situation.

15. The Swedish FSA considers that adverse development in the CRE sector can have a systemic impact on the financial sector and the real economy. CRE firms' level of indebtedness, currently amounting to approximately 35% of Swedish GDP, is linked to the formerly prevailing low interest rate context. In a rising rate situation, these firms might be forced to deleverage under a very tight timeframe, further adding a downward pressure on prices. Such a sector specific stress could heavily impact the financial sector as a whole, which would then translate into a wider stress for the economy, affecting investments at large and particularly the construction sector.

16. The Swedish FSA estimates that the CRE sector size has grown to a significant scale, up to a point where the Swedish banking sector has large exposures to the CRE sector, and CRE firms constitute the banks' largest group of borrowers among non-financial corporates (NFCs). Indeed, approximately 50% of the banks' loans to NFCs (excluding tenant associations) go to CRE firms. When combining all loans to the public (to households, all NFCs and the public sector), it reaches 15%.

17. According to the notification, in addition to the important footprint that the CRE sector has in the banks' balance sheet, it also has an impact on the wider financial system. Although banks' loans remain the largest source of financing for most CRE firms, the Swedish FSA witnesses increased capital market reliance. Financing via capital market increased between 2012 and 2022 from 10% to 35% for listed CRE firm loans. This more diversified funding structure of CRE firms in the last years has led, according to the Swedish FSA, to a situation where the CRE sector

is now more interconnected with both the real and financial sector than before. As such, the Swedish FSA is of the view that any disturbances could more easily spread to and within the financial system, which would ultimately affect the entire economy.

18. The Swedish FSA's proposed measures laid out in the notification replicate, as a Pillar 1 requirement, a Pillar 2 requirement introduced in 2020. Based on Q4 2022 data, the Swedish FSA calculates that the proposed measure will translate into a SEK 18 billion capital requirement, a marginally higher impact than the already in place capital add-on of SEK 17 billion.

19. Therefore, the Swedish FSA considers that the measures would maintain the level of resilience reached via the first measure and would not lead to a detrimental impact on the CRE sector or financial stability. The notification explains that the additional Pillar 2 capital requirement had a limited effect of 0.12bp on bank's interest margin on loans to CRE firms, and that no excess in risk has been taken by banks to maintain profitability.

20. The Swedish FSA believes that the proposed measure is warranted to ensure that banks have enough capital to withstand any potential disruptions in the CRE sector that could otherwise affect banks' financial position and the real economy in general. The measure only targets IRB banks as banks applying the standardised approach assign a minimum risk weight of 50% to their corporate exposures secured by CRE, which the Swedish FSA deems sufficient.

21. The Swedish FSA asks for reciprocity for the measure starting at SEK 5 billion, which is equivalent to about 0.5% of bank lending to CRE in Sweden, which constitutes a lower threshold than the 1% orientation value in the ESRB guidance. In nominal terms, it is equal to the threshold for the reciprocation of the existing Article 458 measure covering retail exposures in Sweden collateralised by residential immovable property, set to SEK 5 billion. Considering the interconnectedness of the financial systems of Nordic and Baltic countries, the Swedish FSA explains that the risks also affect foreign institutions, especially through exposures in branches in Sweden.

Rationale for not using alternative measures

22. Regulation (EU) No 575/2013 (CRR) and Directive 2013/36/EU (CRD) offer various options for addressing macroprudential or systemic risks. Article 458(2)(c) and (e) of that Regulation require 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 Regulation (EU) No 575/2013 and Article 133 and 136 of Directive 2013/36/EU) would be less suitable and effective than Article 458 in dealing with the macroprudential or systemic risk identified.

23. The notification provides a justification of the Swedish FSA's decision to deploy Article 458 of the CRR, in particular the following reasons:

- Regarding the use of Article 124 of the CRR, the Swedish FSA estimates that the relevant Swedish CRE exposures are only to a small extent held by banks applying the standardised approach, whereas exposures that are risk-weighted according to the IRB approach constitute almost all that market. Article 124 of the CRR does not apply to banks using the IRB approach;

- Article 164 of the CRR is not applicable to corporate exposures and hence not possible to use for the exposures in question.

24. The Swedish FSA notes that it already applies a systemic risk buffer of 3% pursuant to Article 133 of CRD to the three major banks, which addresses risks associated with the large, similarly exposed, and concentrated banking sector in Sweden.

25. While applying a sectoral systemic risk buffer (SyRB) could be considered, the notification explains that for reaching the same level of resilience as the measure proposed, the sectoral SyRB would have to be set between 20% to 40% for exposures secured by commercial real estate and 10% to 25 % for residential real estate. A sectoral SyRB is not deemed appropriate as it would be based on varying risk weights, due to the ongoing review of internal models, and would therefore require frequent recalibrations. In addition, it would impact most heavily IRB banks with the highest risk weights and least heavily IRB banks with the lowest risk weights. According to the Swedish FSA, this is not desirable as the measure intends to address risk in banks with low-risk weights.

26. The Swedish FSA highlights that the countercyclical buffer (CCyB) rate under Article 136 of CRD applies to all private credit exposures in Sweden, including those to the non-financial private sector targeted by the proposed measure, and is set at 1% with an increase to 2% in June 2023. According to the Swedish FSA, the CCyB is not suitable for addressing risks related to only a subset of exposures.

Assessment and conclusions

27. Based on the evidence provided by the Swedish FSA, the EBA acknowledges the concerns of the Swedish FSA regarding the financial stability risks stemming from CRE. The EBA recognises that CRE activity levels in the Swedish economy have increased substantially in the last years, imposing a risk on financial stability. CRE firms show high level of indebtedness, and despite having diversified their funding structure, banks remain substantially exposed to a downturn risk in the CRE sector. Amid the changing macroeconomic environment, characterised by increasing interest rates and strong inflation, risks emerge on CRE borrowers’ debt servicing capacity. A sector specific crisis in the CRE could trigger large rippling effects throughout the economy and the financial system and provoke procyclical behaviours by banks and other stakeholders.

28. Furthermore, the EBA notes that the measure proposed by the Swedish FSA replicates an already existing Pillar 2 measure. Therefore, the proposed measure would not add further

resilience to the banking sector but maintain the already built capital add-on that was first imposed on banks in 2020. Given the continued increase in risk stemming from the CRE sector in Sweden since the first implementation of the measure, maintaining the same level of capital requirement seems necessary. Thus, by preserving capital requirements, the implementation of the measure could help banks weather the challenges that might stem from CRE sector firms, either through loss absorption or to maintain their lending capacity to the whole economy.

29. Based on the analysis provided by the Swedish FSA and on the fact that the implemented measure would maintain the level of resilience already built in the Swedish banking sector, the EBA does not object to the implementation of the measure.

30. Nevertheless, the EBA expresses its concerns regarding the proposed measure on several points.

31. The EBA notes that the Swedish FSA decided to switch from a microprudential to a macroprudential measure. The two measures have different rationales, one being a bank-specific capital requirement tailored for a bank's risk profile while the other is not specific to a bank's risk profile. The EBA notes the relevance to tackle risks in the CRE sector, and to distinguish between institution specific risk, among which internal model deficiencies, from financial stability risks.

32. The EBA takes note that the measure proposed by the Swedish FSA is replicating a Pillar 2 measure already applied to banks. Since the implementation of the Pillar 2 measure in 2020, the risks posed by the CRE sector on the banking sector and on financial stability does not appear to have decreased. It is unclear whether the assumptions taken for the introduction of the measure in 2020 remain relevant following the change in the macroeconomic and interest rate environment. As such, the EBA recommends the Swedish FSA to assess on a continuous basis whether the calibration of the measure remains fit for the purpose of diminishing the risks to the banking sector stemming from the CRE sector.

33. The EBA notes that the notification sent from the Swedish FSA sets out 35% and 25% risk-weight floors without providing clear rationale regarding how these risk-weight floors are computed. It is apparent that these are set above the average risk weight applied by IRB banks, but they remain below the standardised approach risk weight. The EBA deems that the notification should have provided further information, in addition to the references provided, on how the risk-weights applied for the purpose of the measure are calculated.

34. Under Article 458 of the CRR, the authority designated should identify a change in the intensity of macroprudential or systemic risk in the financial system and consider that this risk cannot be addressed by means of other macroprudential tools set out in CRR or CRD. An Article 458 measure is meant to be a last resort option in the macroprudential toolbox pecking order. The EBA suggests the Swedish FSA continue assessing the suitability of other macroprudential tools. In this regard, the EBA notes that the implementation of a sectoral SyRB buffer could also contribute to further resilience. In addition to the already implemented SyRB, the sectoral

version of that buffer can be used to increase banks' resilience in the presence of persistent systemic risk. The Swedish FSA notes that, at present, to reach the same level of resilience for each bank, several buffer rates should be implemented not to penalise banks with higher risk weights. While this can be argued, it can also be the case that these risk weights are reflective of the inherent risk of the exposure. Given these considerations, the EBA invites the Swedish FSA to assess on an ongoing basis whether other measures could be used to ensure banks hold sufficient own funds to cover systemic risks related to corporate exposure.

35. The EBA notes that the Swedish FSA intends to request reciprocity of the measure. On this subject, the division between corporate exposures secured by commercial properties and residential properties introduced by the proposed measure is not mirrored in the regulation nor in the supervisory reporting data. Therefore, the request for reciprocity could pose an additional practical challenge which requires a higher level of cooperation between authorities in order not to lead to discrepancies in the application of the measure in different jurisdictions.

36. In light of the persistent risks in the CRE sector in Sweden and the changing nature of macroeconomic risks, the EBA invites the Swedish FSA to closely monitor the situation and to stand ready to reassess the appropriateness of the notified measure. In this regard, the EBA would like to encourage the Swedish FSA to consider other measures which can be suitable to address structural vulnerabilities if the identified systemic risks continue to persist.

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

Done at Paris, 12 June 2023

[signed]

José Manuel Campa

Chairperson

For the Board of Supervisors