

EBA/Op/2017/10

01 August 2017

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 June 2017, the EBA received notification from the Finnish Financial Supervisory Authority (FIN-FSA) of its intention to apply measures referred to in Article 458(2)(d) of Regulation (EU) No 575/2013 of the European Parliament and of the Council (the Capital Requirements Regulation, CRR)¹ to modify capital requirements in order to account for changes in the intensity of macroprudential/systemic risk that could pose a threat to financial stability in Finland.
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 (the EBA Founding Regulation) and subparagraph (2) of Article 458(4) of the CRR. Article 458(2) of the CRR 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 for 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. Specifically, Article 458(2) refers to stricter national measures that can be taken to address the level of own funds, requirements for large exposures, public disclosure requirements, the level of the capital conservation buffer, liquidity requirements, risk weights for targeting asset bubbles in the residential property and commercial immovable property sector, or intra financial sector exposures.

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. Within one month of receiving the notification, the EBA is required to provide its opinion on the points referred to in Article 458(2) of that Regulation to the Council, the Commission and the Member State concerned.
4. In accordance with Article 14(5) of the rules of procedure of the EBA, the Board of Supervisors has adopted this opinion.

Background of the measure

5. The measure consists of a credit institution-specific minimum level of 15% for the average risk weight on residential mortgage loans applicable to credit institutions that have adopted the Internal Ratings Based (IRB) approach. The minimum level would come into force on 1 January 2018.
6. The measure targets residential mortgage loans where the collateral is located in Finland, and will be applied on a consolidated basis. IRB credit institutions hold 90% of the residential mortgage loan market and the three systemically important credit institutions account for the majority of house lending, with over 80% of the stock of residential mortgage loans in the Finnish market. Six credit institutions will be affected by the proposed measure.

Economic rationale for the measure

7. The changes in the intensity of macroprudential/systemic risk underlying the measure are described by the FIN-FSA as:
 - strong growth in residential mortgage-related debt resulting in a structurally high level of household indebtedness relative to annual disposable income (127.1% in Q1 2017, compared with 67.5% in 2000);
 - high vulnerability of households because a majority share of residential mortgage loans is tied to variable interest rates;
 - housing accounting for a significant proportion of Finnish households' total assets and the high proportion of housing loans among the euro-denominated loans granted by Finnish credit institutions (47% at end 2016);
 - high loan-to-value (LTV) ratios at origination.
8. This change in the intensity of macroprudential/systemic risk is seen to pose a threat to financial stability in Finland, in particular because of the high household indebtedness and large stock of residential mortgage loans. In addition, the share of credit institutions' funding consisting of covered bonds secured by residential mortgage loans has increased (31.1% of credit institutions' market funding and 40.6% for total bond funding). Last, Finnish credit institutions that use IRB approaches report relatively low average risk weights (7.9%). The FIN-FSA states that this is confirmed by the Nordic Risk Weights Benchmarking Analysis 2017,

which reported the exposure weighted average levels for Finland (7%) against Sweden (25%), Norway (25%) and Denmark (13%).³

9. These findings regarding the risk weights are also reflected in supervisory data reported to the EBA. Indeed, the levels of reported average IRB risk weights on retail exposures secured by real estate property are 9% for Finland, 7% for Sweden, 22% for Norway and 15% for Denmark (see Table 1). It should be noted that the apparent difference in the figure for Sweden is explained by the fact that the supervisory reporting data do not include the effect of all macroprudential measures taken. The data capture the Norwegian measure under Article 164, i.e. an increase in the minimum Loss Given Default (LGD) from 10% to 20% for retail exposures secured by residential real estate, while the effect of a Swedish measure taken under Pillar 2, setting a risk weight floor on Swedish mortgages of 25% for IRB banks, is not reflected. A similar but smaller difference in risk weights between institutions from Nordic countries can be observed by comparing risk weights for exposures towards Finnish counterparties.

Table 1: Total average IRB risk weights of retail exposures secured by real estate property for selected countries (Q1 2017)

Country	Total	To Finnish counterparties
FI	9%	9%
NO	22%	31%
SE	7%	11%
DK	15%	17%

10. The FIN-FSA therefore sees a need to shelter credit institutions with capital buffers from credit losses that would be caused by a potential downturn in the residential mortgage market and to ensure that institutions maintain the ability to lend in such a downturn. Notably, the loan losses in this respect could also stem from second-round effects when households reduce consumption in a stress situation.
11. The measure applies an average risk weight floor because an average is seen as less intrusive in term of effects on credit pricing and risk-based allocation of credit to the real economy. This risk weight floor is calculated as an Exposure at Default (EAD)-weighted average.
12. The minimum level for the average risk weight was calibrated to be sufficient to cover loan losses from a severe financial crisis. As a benchmark for the calibration, the Finnish financial crisis of the 1990s and residential mortgage crises experienced by other European countries have been used. It is estimated that based on this measure the capital requirement for Finnish

³ The figures for Sweden and Norway include additional requirements.

credit institutions will increase by approximately EUR 450 million. However, the introduction of the macroprudential measure will not cause a need for Finnish credit institutions to raise or increase capital. According to the impact assessment carried out by the FIN-FSA, the increase in the residential mortgage loan margin for the credit institutions with the lowest average risk weights would be at most 0.1 percentage points, while the impact on credit institutions' Common Equity Tier 1 (CET1) ratio is estimated to be between 0 and 2 percentage points. For two credit institutions the impact is close to 0%.

13. The measure is not directly targeted at reducing the high level of growth in indebtedness. For this purpose the FIN-FSA has already introduced a loan-to-value limit (90%), and has publicly spoken in favour of introducing income-based instruments as part of the national macroprudential tool-kit (mainly loan-to-income, debt-to-income and debt service-to-income). Instead, the measure addresses primarily the potential impact on credit institutions.

Rationale for not using alternative measures

14. The CRR and Directive 2013/36/EU (CRD) offer various different options for addressing credit institutions' vulnerabilities: Article 458(2)(c) of the CRR 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 the CRD) cannot adequately address the macroprudential or systemic risk identified, taking into account the relative effectiveness of those measures.

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

- Article 124 of the CRR does not apply to credit institutions using the IRB approach.
- Increasing the LGD floor for mortgage loans as per Article 164 of the CRR would widen the differences in risk weights between institutions and result in a (disproportionate) increase in risk weights for some credit institutions. According to the FIN-FSA, this is because the LGD floor is already binding and Probability of Default (PD) values vary widely between Finnish credit institutions. PD values of Finnish banks would still remain at their current levels if Article 164 were used. In this case, with the IRB risk weight formula as a linear function of the LGD parameter, an increase in the LGD floor has a linear (or close to linear) unwanted impact on average risk weights, i.e. higher LGDs would ceteris paribus multiply with current risk weights. In this way, an increase in LGD floor would have the biggest impact on the credit institutions with the highest initial average risk weights, leading to a widening of differences between credit institutions. Also, in order to have the same impact as the proposed measure, i.e. minimum 15% risk weights, the minimum LGD would need to be raised to 30%. Moreover, the need for an increase in risk weights on mortgage lending is not related to low LGD values (the average LGD is close to 10%).

- Articles 101 and 102 of the CRD would not be applicable, as existing models are based on valid statistical microprudential data but do not take into account the additional systemic risk and the second-round effects deriving from an overall high level of mortgage lending and house indebtedness. The FIN-FSA states that IRB models are developed on the basis of banks' granular data that do not cover severe loss scenarios such as the 1990s banking crisis. To account for this, Finnish banks have made adjustments to their models to account for the said crisis's loss levels. However, these adjustments do not reflect the current higher level of household indebtedness. Thus, despite the correction to the models, risk weights of banks' models do not fully take into account the risks apparent today. The FIN-FSA also states that amending the IRB parameters would not be as effective as the proposed measure, because of the time required for its implementation. Indeed, all relevant competent authorities would need to agree and take coordinated action accordingly. Moreover, the FIN-FSA states that only one institution is currently subject to a model review and that there is no other evidence that credit institutions with low risk weights are underestimating their exposures' microprudential risk.
- The application of Articles 103 and 104 of the CRD would not be effective for a number of reasons. First, capital requirements introduced by the FIN-FSA or ECB based on these Articles apply to individual credit institutions registered in Finland. A large and growing part of the Finnish mortgage market is held by branches of foreign credit institutions, and Nordea, headquartered in Sweden, transformed the major part of its Finnish activities into a branch in early 2017. Moreover, for Significant Institutions the ECB is in charge of applying Pillar 2 as a macroprudential tool. Second, the reciprocation would be challenging and require coordination among all authorities involved. The view on the use of Pillar 2 for macroprudential purposes is not uniform among supervisors. Third, publication practices vary among Member States, so the publication of a macroprudential measure would have a limited beneficial effect on stability, weakening the possibility of a widespread impact on the whole banking system.
- Regarding Article 133 of the CRD (systemic risk buffer, SRB), despite the work on implementing the SRB, the process is currently delayed and might not be completed in the previously expected timetable. In addition, the outcome and the timing of the implementation are still uncertain and the measure will become effective only 12 months after the parliament's decision. The FIN-FSA states that, for instance, assuming that the proposal is sent to parliament in 2018, the SRB would become effective only in 2019 as a result of the 12-month implementation period. Therefore, since the SRB will not be available at once, and since there is no reference in Article 133 to the application of the SRB to sectoral exposures, the proposed measure can be more effective. Moreover, even if the SRB could be limited to residential real estate exposures, the effects of the buffer are estimated as different from those of a risk weight floor. In particular, the buffer would increase the capital requirement more for credit institutions with higher residential mortgage loan risk weights, whereas the proposed measure aims to ensure sufficient capital across the whole banking sector.

- Article 136 of the CRD (countercyclical capital buffer) is a cyclical measure whereas the macroprudential/systemic risk addressed by the FIN-FSA is structural. In addition, the countercyclical capital buffer applies to the aggregate credit stock, whereas the risk identified concerns real estate mortgages only.

Assessment and conclusions

16. Based on the evidence provided by the FIN-FSA and also based on the recent analyses of the European Systemic Risk Board,⁴ the EBA acknowledges the macroprudential risks in the Finnish economy related to residential mortgage loans and residential mortgage indebtedness.
17. However, the EBA sees some open questions regarding the choice of measure, the calibration of the measure and the impact of the measure, which the EBA would like to bring to the attention of the European Commission.
18. It is stated in the notification that reviewing the permission to use internal approaches under Article 101 of the CRD, aiming to amend IRB parameters, would not be effective because existing credit institutions' models were based on validated statistical data. However, resulting risk weights are still seen as too low at 7.9%. Here the argument is that risk weights do not take into account the additional systemic risk to the real economy, caused for example by second-round effects. The calibration of the measure was chosen to be sufficient to cover the loan losses in a severe risk scenario like the 1990s banking crisis in Finland. No quantification of potential second-round effects is provided in the notification. If risk weights of Finnish institutions were too low to cover the severe economic crisis independent of any additional systemic risks, a review of internal models based on Articles 101 and 102 of the CRD could also be an effective measure to increase risk weights. Given that banks already adjust their models to account for this crisis, it is also not clear why, if this adjustment is seen as insufficient, a higher adjustment is not possible as part of a Pillar 1 model review. It is, however, acknowledged that an IRB model review would take time and resources, therefore requiring earlier planning and leaving limited choices in the short term.
19. The FIN-FSA also states that, while there is no clear evidence of differences between risks in credit institutions' residential mortgage loan exposures, the risk weights are heterogeneous between Finnish banking groups. This is also reflected in the fact that the proposed floor has only a negligible impact for two Finnish credit institutions because they have relatively higher initial risk weights. Here it is unclear why, if the measure addresses a systemic risk not captured by Pillar 1 models, it should not result in higher requirements for some credit institutions. This observation would also indicate that Pillar 1 models should be reviewed. In this context it is worth noting that the risk weights for Finnish institutions are below those

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https://www.esrb.europa.eu/pub/pdf/warnings/2016/161128_ESRB_FI_cover_letter.en.pdf?df3781b949ecff6bc735d89aed1bbb2a

from other Nordic countries when comparing only IRB retail exposures secured by real estate property towards Finnish counterparties (see Table 1).

20. The notification states that the measure is mainly addressing structural risks, in particular high household indebtedness, credit institutions' large exposures to residential mortgage loans, credit institutions' high level of dependence on wholesale funding and covered bonds, and a highly interconnected and concentrated banking sector. Therefore, even though it is pointed out by the FIN-FSA that there is also a cyclical element embedded in the possible asset price bubble in the residential real estate sector, the measure is to be introduced to reduce risks stemming from all these structural factors. Pillar 1 models are not meant to capture these sorts of structural risks. Here a risk weight add-on could be more effective than a risk weight floor. The introduction of a risk weight floor entails that, as stated above, the measure has no or only a small impact for those credit institutions close to or above the floor.

21. In general, the adjustment of risk weights has certain negative implications that were already described in the EBA Report on the range of practices regarding macroprudential policy measures⁵ and that should also be considered in this instance:

- Measure can make risk weights across credit institutions less comparable.
- Measures that are calibrated based on stress tests can lead to a double counting of risks and capital requirements in following stress-testing exercises.

22. It should therefore be taken into consideration that the structural risks could also be addressed with the same impact on credit institutions by setting an institution-specific SRB. Indeed, only applying the same level of SRB to all credit institutions will result in a higher increase in capital requirement for credit institutions with a higher share of residential mortgage loans or with higher risk weights for these loans. However, an institution-specific buffer can lead to a similar effect to that of a risk weight floor. The process of introducing an SRB was already started by the Finnish government, and the EBA is of the opinion that it could be more efficient than the proposed measure, as well as fully transparent. The setting of an SRB would also avoid any potential overlaps with Pillar 2 capital requirements or Pillar 2 guidance based on a stress test involving residential mortgage exposures as well as related Pillar 2 requirements, for example for concentration risks. Therefore, at the latest once the SRB is implemented in national legislation and available to the FIN-FSA, the situation should be reassessed.

23. Regarding the impact of the measure, it is stated by the FIN-FSA that the introduction of the measure will lead to an additional capital requirement of EUR 450 million. However, this is already well covered by the existing capital buffers of Finnish institutions. As the measure will therefore have no impact in terms of additional capital it is not fully clear how the main

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<http://www.eba.europa.eu/documents/10180/950548/EBA+report+on+the+range+of+practices+regarding+macroprudential+policy+measures.pdf>

objective, i.e. to ensure credit institutions can withstand loan losses, is achieved by the measure. However, it is acknowledged that the measure can ensure that existing capital, currently held in the form of voluntary capital buffers, is maintained in the system in the form of Pillar 1 requirements, and that a public measure can also have a signalling effect.

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

Done at London, 01 August 2017

Andrea Enria

Chairperson

For the Board of Supervisors