



EBA/Op/2018/01

23 February 2018

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

Introduction and legal basis

On 22 January 2018, the European Banking Authority (EBA) received notification from the National Bank of Belgium (NBB) of its intention to apply Article 458(2) of Regulation (EU) No 575/2013 of the European Parliament and of the Council (the Capital Requirements Regulation – CRR).¹ A previous measure was introduced by the NBB in 2014 and subsequently extended until May 2017 to modify capital requirements in order to account for an increase in macroprudential risk. The NBB subsequently issued a non-binding recommendation to the Belgian internal ratings based (IRB) banks to maintain prudent credit conditions and keep capital conforming to the 5 percentage point (pp) risk weight add-on on a voluntary basis.

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 and Article 458(4) of the CRR. Article 458 of the CRR requires designated or competent authorities entrusted with the national application of that provision to notify the EBA if the authority identifies changes in the intensity of macroprudential or systemic risk in the financial system that have the potential to have serious negative consequences for the financial system and the real economy in a specific Member State and that the authority considers would be better addressed by means of stricter national measures. Within one month of receiving the notification, the EBA is required to provide its opinion on the points in Article 458(2) CRR to the Council, the Commission and the Member State concerned. In accordance with Article 14(5) of the Rules of Procedure of the Board of Supervisors,³ 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.

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 Decision adopting the Rules of Procedure of the European Banking Authority Board of Supervisors of 27 November 2014 (EBA/DC/2011/001 Rev 4).

Background to the measure

The notification from the NBB pertains to the replacement of the expired measure, which consisted of an increase in risk weights for retail exposures secured by Belgian residential immovable property for Belgian IRB banks, introduced on the basis of Article 458 of the CRR in May 2014 and subsequently extended until May 2017.

The notification proposes the introduction of a new macroprudential measure based on two components, the first of which consists of a flat 5 pp risk weight add-on to the microprudential risk weight for mortgage exposures for IRB banks (identical to the measure that expired in May 2017); the second, more targeted component would further increase risk weights in line with the risk profile of the bank's mortgage portfolio by applying an additional proportional 33% macroprudential risk weight add-on on top of the microprudential risk weight to be applied to each (IRB) bank's (residential) mortgage portfolio.

In this way, the total risk-weighted assets (RWAs) for IRB banks' retail exposures secured by immovable property situated in Belgium would be determined by the inclusion of the 5 pp risk weight add-on plus a multiplier of 1.33 for the microprudential risk weights of the Belgian mortgage portfolio. It should be noted that the NBB confirmed that the proposed measure would affect total RWAs and, therefore, the minimum Pillar 1 capital requirements that institutions have to meet at all times according to Article 92 of the CRR; the measure would increase the overall RWAs of banks and, as a result, additional capital would be needed to meet these requirements. For this reason, the NBB refers to this additional capital as the additional 'capital buffer' generated by the proposed macroprudential measure. The additional required capital would function as a macroprudential buffer, as the NBB could decide to release the additional requirement in the event that the risk were to either abate or materialise.

The calibration of the proposed measure is based on an assessment of credit losses under stress scenarios for the real estate market and aims to increase banks' capital requirements sufficiently. The NBB's simulations include a benchmark stress scenario consisting of a multiplication of the default rate by 5 and an increase in loss given default (LGD) of 25 pp, and complementary scenarios that additionally impose a minimum default rate per institution (through the introduction of a floor on default rates of 4% and 5%). The NBB concluded, after these simulations, that the capital buffer for residential real estate exposures of IRB banks might, on average, be insufficient to absorb potential losses in the event of severe stress. Hence additional requirements may be required to absorb such losses.

A first macroprudential measure under Article 458 of the CRR was notified to the EBA on 1 April 2014 and was introduced following the European Commission's decision not to object,



which was notified to the NBB on 28 May 2014.⁴ On 21 January 2016, the EBA received notification from the NBB that it intended to extend the measure. In its opinion of 19 February 2016,⁵ the EBA did not object to the NBB's proposal and the measure was subsequently extended until 28 May 2017, and eventually a non-binding recommendation was issued to the Belgian IRB banks to maintain prudent credit conditions and keep capital conforming to the 5 pp risk weight add-on on a voluntary basis. While acknowledging that the increases in house prices and debt levels, in combination, could pose a threat to the financial stability of banks in Belgium, the EBA, in both of its opinions, also raised some issues relating to the calibration of the specific measure and the use of other measures and to the legal basis for addressing the problem. The EBA observed that the issue underlying the macroprudential measure could at least partly and in the longer term be addressed by requiring changes in banks' IRB models, given that risk weights for Belgian IRB institutions were seen as too low; the appropriateness of the risk weight level in the light of a potential worsening of conditions in the Belgian housing market could have been further assessed based on stress tests as part of the Supervisory Review and Evaluation Process (SREP). The governance constraints on the use of Pillar 2 as an alternative measure, mentioned by the NBB, were recognised but deemed to be outside the scope of the assessment by the EBA required by paragraph (2) of Article 458(4) of the CRR.

Opinion on the measure

Economic rationale for the measure

According to the notification submitted by the NBB, the proposed measure follows close monitoring of developments in the Belgian real estate market, the sustainability of household indebtedness and the quality of banks' loan portfolios, which has been undertaken since the introduction of the first macroprudential measure. Through this measure, the NBB intends also to address the November 2016 European Systemic Risk Board (ESRB) warning, in which the ESRB identified the main vulnerabilities in the Belgian residential real estate sector.

The NBB has observed that, while default rates on mortgage loans in Belgium have remained fairly stable in the recent past, the housing market has slowed down somewhat. Figures on nominal property prices for 2015 point to an increase in prices in that year, followed by a marked deceleration in the growth rates of real estate prices in 2016, which are finally rising again according to the latest data, for Q2 of 2017. In addition, estimates based on benchmark valuation measures performed by the NBB indicate the materialisation of high valuations and a certain degree of overvaluation in the residential real estate market in Belgium, which is currently in the range of 0–10%.

A number of factors could result in increasing credit losses on banks' mortgage portfolios following price decreases for residential real estate, namely the continued expansion of mortgage lending to

⁴ EBA/OP/2014/02, Opinion of the European Banking Authority on measures to address macroprudential or systemic risk, 30 April 2014.

⁵ EBA/OP/2016/03, Opinion of the European Banking Authority on measures in accordance with Article 458 Regulation (EU) No 575/2013, 19 February 2016.



Belgian households (with a growth rate of around 5.6% in September 2017), as a result of low interest rates; a sharp increase in the debt ratio of households (59.8% of GDP in Q2 of 2017 compared with 38.4% in Q1 of 2002); a high proportion of loans in the riskiest segments, especially with regard to the proportion of new loans with high loan-to-value (LTV) ratios (> 90%), which have oscillated around 30% in recent years; and a renewed tendency to lengthen loan maturities, observed in 2017 (while IRB banks had previously been shortening loan maturities, the percentage of loans granted with a maturity of more than 25 years increased in production volumes from 1.5% in 2016 to 1.7% in 2017). These developments were accompanied by an average IRB risk weight for mortgage loans (before taking into account the macroprudential measures) remaining stable at approximately 10% in 2015 and 2016.

After an analysis of banks' business plans, the NBB expects sustained new mortgage lending in the coming years. This may intensify competition between the main credit institutions, triggering increased risk-taking in the form of further easing of credit standards. Overall, even if a tightening of credit standards were to occur through the shortening of loan maturities, the more recent data indicate that other signals are emerging regarding the loosening of other credit standards (with respect to LTV ratios, debt service to income ratios, and margins). The main argument is that, although the previous measure was effective in building up the resilience of the IRB banks, it is no longer sufficient in the light of the growing exposures of the banks and the discontinuation of credit standards tightening in recent years, especially in the riskier loan segments. Indeed, the NBB notes that there has been no reduction in the market share of 'riskier loan segments' since 2015 (while also acknowledging that, more recently, signs of some deterioration in these loan conditions have been observed) and, therefore, concludes that the proposed measure would not only provide sufficient capital supply in a severe downturn scenario but also introduce a behavioural component that would further discourage excessive credit risk-taking by IRB banks.

Rationale for not using alternative measures

The CRR and Directive 2013/36/EU (the Capital Requirements Directive – CRD) offer various options for addressing banks' vulnerabilities, and Article 458(2)(c) of the CRR requires the designated authority to explain why a stricter national measure is necessary and why other possible measures (i.e. those pursuant to Articles 124 and 164 of the CRR and Articles 101, 103–105, 133 and 136 of the CRD) cannot adequately address the macroprudential or systemic risk identified, taking into account the relative effectiveness of those measures.

The notification provides a comprehensive justification of the NBB's decision to deploy Article 458 of the CRR. In particular, it claims that:

- Article 124 of the CRR would not be adequate, since it is applicable only to banks using the standardised approach for exposures towards residential real estate. For such exposures, representing about 5% of the market share at the end of 2017, the 45% risk weight is considered sufficient by the NBB.



- Increasing the exposure-weighted average LGD floor for mortgage loans in accordance with Article 164 of the CRR is not an option that the NBB believes should be pursued, since the proposed measure aims to impose an additional macroprudential capital requirement (rather than using a measure of a microprudential nature) based on the general risk profile of the respective banks' portfolio (risk weights).
- Moreover, the proposed macroprudential requirement will not affect banks' internal models, whereas Article 164 would lead to a change in their internal models. The NBB also claims that an increase in the average LGD floor under Article 164 would have implications beyond the calculation of risk-weighted exposure amounts and would, for example, also apply to the calculation of expected loss amounts.
- As regards Articles 102, 103 and 104 of the CRD, the NBB lists a series of arguments against their use in this specific case. First, the proposed measure is to be applied to all banks applying internal models and it is not based on the risk assessment made pursuant to Article 97 of the CRD on an individual basis. In addition, under Regulation No 1024/2013, the NBB is no longer the competent authority for Belgian banks using an internal model and could not deploy measures under Articles 103 and 104 of the CRD. In addition, the NBB observes that the use of Articles 103 and 104 would be less transparent, as Pillar 2 measures are currently not publicly disclosed. There is, in addition, a point to be considered regarding the scope of the measure, since, while the risk weight add-on would apply to both the outstanding stock of mortgages and the flow of new loans, a Pillar 2 capital requirement would be based on a time-specific assessment of the outstanding stock, taking into account that Pillar 2 decisions are taken only once a year. Increasing the required Pillar 2 Common Equity Tier 1 (CET1) ratio in order to reflect the amount of capital needed to cover the new measure on mortgage loans would also affect the capital requirements related to credit and exposures other than mortgage loans. This is not in line with the aim of the measure, which is to target only mortgage loans.
- The NBB notes that Articles 101 and 102 of the CRD would not be applicable, as the banks using IRB models comply with all the requirements of the CRR and there is no evidence of a breach of this Regulation. A review of internal models carried out by the NBB in 2014 has not revealed generalised problems relating to the outcomes of internal models, confirming that the low risk weights are simply the result of historical data not incorporating any major property crisis in Belgium. In addition, the risk weight add-on would be implemented to mitigate a macroprudential risk stemming from adverse developments in the real estate market and increasing vulnerability on the part of borrowers, and not in order to correct a microprudential issue of potential miscalibration of internal models. While risk weights should correctly reflect (microprudential) risks, recalibrating the models is neither an adequate nor a sufficient response to the identified macroprudential risks, in the opinion of the NBB.
- As regards Article 133 of the CRD, the NBB notes that the increase in the risk weight for residential mortgage loans is proposed to limit the risk of a potential cyclical downturn in



the residential real estate market and not to mitigate structural risks as the systemic risk buffer would do. In addition, the systemic risk buffer cannot be applied to specific asset classes. Similarly, the countercyclical buffer, pursuant to Article 136 of the CRD, applies to all credit exposures to the non-financial private sector located in a jurisdiction and, therefore, would not achieve the objective of the proposed measure.

Assessment and conclusions

The main argument put forward in the notification is that, while developments in the Belgian property market (particularly the increase in real estate prices along with high LTV levels and the rising indebtedness of the household sector) continue to be a source of concern, risk weights for exposures towards residential mortgages may not sufficiently reflect the potential credit losses that could occur in a downturn. Moreover, the proposed measure aims to address the high proportion of riskier mortgage loans extended by IRB banks in Belgium in the context of intensifying household credit risk-taking, by targeting more explicitly the riskier segments and discouraging this type of mortgage loan.

The EBA acknowledges, in line with the ESRB warning on the vulnerabilities of the residential real estate sector, 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, and it does not object to the deployment of macroprudential measures. Based on the feedback received from the other EU competent authorities, the potential for the proposed measure to have a negative impact on the Single Market seems limited.

However, some general observations are made:

- The use of an add-on in the form of a multiplier on the risk weight of the residential mortgage loan portfolio (or any other measure changing the risk weight, including through the application of Article 164) would add further complexity to the determination of capital requirements and could reduce the transparency of risk weights for market participants. This issue arises because risk weight add-ons affect Pillar 1 requirements and cannot be differentiated from other factors contributing to Pillar 1 requirements by all market participants (other than the banks targeted by the measure). It should be noted that the reduced transparency would also apply to Article 164 (and for any other macroprudential measure) applied to exposure amounts that are not public. It should also be noted that, even if a public communication were to be made on the application of the proposed measure, it would not be possible for market participants to recalculate the present add-ons, considering the lack of detailed information on residential mortgage loan portfolios in the current COREP and FINREP standards.
- The NBB reports that the calibration aims to increase banks' capital requirements sufficiently to maintain the loss absorption capacity of the banking sector, and it does so through the use of a stress test model. The NBB's stress scenarios revealed that additional capital would be needed to absorb potential losses in the event of severe stress. The two



components of the measure were then calibrated so as to cover the identified capital shortfall; the second component of the measure – the risk weight multiplier – is calibrated such that the identified losses would, on average, be covered, while the 5 pp RWA add-on should maintain business continuity. The proposed measure would substantially increase RWAs for residential real estate exposures (by pushing up the implied risk weights on mortgage exposures from 9.7 % to 17.9% on average), implying that the total impact would correspond to an 85% increase in the capital buffer compared with the microprudential CET1 capital requirement for this portfolio. An assessment of credit losses under stress scenarios for the real estate market is used as a means of calibration for the measure. The use of severe stress scenarios with increases in banks' probability of default (PD) and LGD to account for the capacity of the capital buffer to absorb potential losses in the event of severe stress is undertaken without reference to the EU-wide stress scenarios or other supervisory stress tests. It is, therefore, unclear from the notification how residential real estate risks are already indirectly covered in capital requirements and Pillar 2 guidance for Belgian banks through stress tests such as the EU-wide stress test. For example, the EU-wide stress test in 2016 included a fall in house prices in the underlying scenario, and banks were measured against the impact in terms of Pillar 1 capital requirements.

- Additionally, it is noted that the adverse scenario of the recently launched 2018 EU-wide stress test foresees a more severe decline in Belgian house prices than in any other previous stress test (with a price level deviation from the baseline of –32.8% in 2020 against an EU average of –27.7%). As already stated in the EBA's report on practices regarding macroprudential measures,⁶ 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. This calls, at least, for close monitoring of the impact of the proposed measure and its interaction with the Pillar 2 guidance to be set this year following the finalisation of the EU-wide stress test.
- The assumption behind the second component is that banks are correctly estimating risk weights and that risk weights are a good proxy for portfolio riskiness. While this might be true in general, there is still a risk of penalising banks with more conservative internal models and higher starting risk weights. The EBA is therefore of the opinion that the multiplier could have a distorting effect, since it would reduce the incentive to estimate conservative risk parameters. On the other hand, the application of Article 164 could result in distorting effects as well. In particular, by increasing the average LGD floor, banks with conservative lending standards (implying a lower LGD) would be penalised and could be incentivised to align their risk-taking with the higher (less conservative) LGD floor.
- The NBB states that it evaluated the adequacy of the calibration of the PD and LGD models used in the regulatory capital calculation within the IRB approach. On average, no major weaknesses such that Article 101 of the CRD would not be applicable were observed.

⁶ *EBA report on the range of practices regarding macroprudential policy measures communicated to the EBA, July 2015.*



However, the notification implies that risk weights for Belgian IRB institutions are seen as too low, in particular for high LTV buckets. The EBA therefore, as in its previous opinions of 30 April 2014 and 19 February 2016, continues to argue that the issue underlying the macroprudential measure could at least partly and in the longer term be addressed by making changes to banks' IRB models. The EBA also notes that the publication of the results of the targeted review of internal models (TRIM) exercise as well as changes introduced by the EBA Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures, in addition to the related ongoing EBA work on LGD estimates appropriate for an economic downturn might eventually trigger adjustments to such models. This should happen in parallel with the regular monitoring and review of the proposed measure. The results of the 2016 high default portfolios (HDP) benchmarking exercise shows that IRB banks in Belgium have low default and loss rates for residential mortgages compared with the aggregate EU level. This may confirm the need to monitor closely the outcome of the assessment of the internal models of Belgian banks.

- When referring to reasons not to make use of other measures, the NBB states that Article 164 of the CRR is a microprudential measure, while the new measure aims to impose an additional macroprudential buffer, over and above the current microprudential requirements. In this regard, it is noted that Article 164 accounts for the possibility of adjusting the exposure-weighted average floor, taking into account forward-looking immovable property market developments, and is not limited to purely microprudential use. Regarding the use of Articles 102, 103 and 104 of the CRD, the NBB refers to the role of the European Central Bank (ECB) as the competent authority for a Belgian Significant Institution using an internal model. As stated in Article 458 of the CRR, Member States must refer to the designated competent authority, which may apply the SREP if necessary. A reasoning solely based on governance matters, when taken in accordance with Article 458, shall not be taken as sufficient justification. In addition, the EBA believes that Pillar 2, if clearly communicated and disclosed, can have an effect also on the flow of new loans and not just on the stock, and can target mortgage exposures as well as having a signalling effect to the market. While it is correct that the use of Pillar 2 would reduce the impact of any other capital buffer, this could be seen as a positive separation of capital requirements for different purposes. The EU-wide stress test includes projections of credit losses on banks' domestic mortgage portfolios and an adverse scenario projecting a severe decline in house prices. This exercise targets risks similar to those covered by the proposed measure, regardless of the prudential framework applied.
- The EBA agrees 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. Given the cyclical and portfolio-specific nature of the proposed measure, it is of utmost importance, as argued by the NBB, that the NBB continues to monitor the developments in the property market and to reassess the rationale for such measures over time.



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

Done at London, 21 February 2018

Andrea Enria

Chairperson

For the Board of Supervisors