ESRB
European Systemic Risk Board
European System of Financial Supervision

Assessment of the Swedish notification in accordance with Article 458 of Regulation (EU) No 575/2013 concerning the application of a stricter national measure for residential property and commercial immovable property

Introduction

On 12 May 2023 Finansinspektionen notified the European Systemic Risk Board (ESRB) of its intention to apply a stricter national measure concerning risk weights under Article 458(2)(d)(iv) of the Capital Requirements Regulation (CRR)[1] in accordance with Article 458(9) of that Regulation. Finansinspektionen is the designated authority for the purpose of Article 458 of the CRR in Sweden. The proposed measure is a risk weight floor of 35% for certain corporate exposures secured by commercial properties (physically located in Sweden for commercial purposes in order to generate a rental income) and a risk weight floor of 25% for certain corporate exposures secured by residential properties (physically located in Sweden for commercial purpose in order to generate rental income).[2] The proposed measure applies to credit institutions that use the internal ratings-based (IRB) approach for calculating regulatory capital requirements.

Pursuant to Article 458(4) of the CRR, the ESRB must provide the Council, the European Commission and Sweden with an opinion within one month of receiving the notification.
The opinion must be accompanied by an assessment of the proposed measure in terms of the points mentioned under Article 458(2) of the CRR. The procedural framework for the provision of opinions under Article 458 of the CRR is clarified in Decision ESRB/2015/4[3].

The ESRB's assessment focuses on the net benefits of the proposed measure for maintaining financial stability. In particular, the ESRB has assessed the rationale and merit of the measure against the following criteria:

- **Justification**: Has there been a change in the intensity of systemic risk and does it pose a threat to financial stability at the national level? Can alternative instruments provided for under CRD[4] and CRR adequately and appropriately address the risk, taking into account their relative effectiveness?

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1 See Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

2 The following properties are not covered: (i) agricultural properties, (ii) properties owned directly by municipalities, states and regions, (iii) properties where more than 50 percent of the property is used for own business (not rental), and (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.

3 Decision of the European Systemic Risk Board of 4 of 16 December 2015 on a coordination framework for the notification of national macroprudential policy measures by relevant authorities, the issuing of opinions and recommendations by the ESRB, and repealing Decision ESRB/2014/2 (ESRB/2015/4), as amended by Decision ESRB/2021/7.

4 See 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, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

- **Effectiveness**: Is the measure likely to achieve its intended objective?
- **Efficiency and suitability**: Will the measure achieve its objective in a cost-efficient way, i.e. are the instrument and calibration appropriate?
- **Proportionality and impact on the internal market**: Is there an appropriate balance between the costs resulting from the measure and the problem it aims to address, taking into account any potential cross-border spillover effects? Where appropriate, the ESRB may suggest amendments to the measure to mitigate potential negative spillover effects.

The ESRB's assessment draws on the information provided by, and discussions with, Finansinspektionen and its staff.

Section 1: Description and background of the proposed measure

1.1 Description of the proposed measure

The proposed measure consists of a credit institution-specific risk weight floor of 35% for certain corporate exposures in Sweden secured by commercial properties, and a credit institution-specific risk weight floor of 25% for certain corporate exposures in Sweden secured by residential properties. The measure is intended to address the elevated systemic risk related to the real estate sector in Sweden. It targets exposures in the exposure class corporate and can be both exposures secured by such commercial and residential properties. In this assessment, corporate exposures secured by commercial or residential properties are also called commercial real estate (CRE) exposures. Currently, the share of CRE secured by commercial properties and by residential properties in Sweden is roughly equal. The measure is intended to target properties that are owned to generate income through rental to tenants.

The proposed measure applies to credit institutions licensed in Sweden that are authorised to use the IRB approach for calculating regulatory capital requirements for retail exposures ("IRB credit institutions") . The measure applies to these institutions on an individual and consolidated level. According to the Swedish authorities, the average (exposure-weighted) risk weight for IRB credit institutions is around 17% for corporate exposures secured by commercial real estate and 13% for corporate exposures secured by residential real estate (RRE).

The proposed measure would enter into force on 30 September 2023 for a duration of two years and would replace an existing institution specific Pillar 2 requirement. Finansinspektionen introduced an institution specific Pillar 2 requirement for IRB credit institutions, which entails a capital add-on corresponding to a 35% average risk weight for certain corporate exposures secured by CRE in Sweden and a 25% average risk weight for certain corporate exposures secured by RRE in Sweden. The intention is to replace these requirements with the proposed measure under Article 458 of the CRR, therefore the Pillar 2 requirement would expire upon its introduction. The proposed measure is expected to be in existence from 30 September 2023 until 29 September 2025, or until the macroprudential or systemic risks cease to exist (if before this date).

Finansinspektionen intends on requesting reciprocation for the measure by other Member States given the potential for Member State banking sector exposures, via branches or direct cross-border exposure, to the risk related to the CRE market in Sweden. This request will be considered in greater detail by the ESRB in a separate assessment and potential recommendation.

1.2 Background of the measure

The proposed measure will complement a set of macroprudential instruments already in use by the Swedish authorities. Currently, the other macroprudential policy tools in use are the following:

- A loan-to-value (LTV) limit of 85% on new housing loans.
- Amortisation requirement: new borrowers with mortgages in excess of 4.5 times their gross income must amortise at least 1% of the debt in addition to the existing amortisation requirement. New borrowers with mortgages with LTVs of between 50% and 70% must amortise at least 1% while those with mortgages with LTVs of above 70% must amortise at least 2%.
- An O-SII buffer of 1% applicable to four credit institutions, all of which use the IRB approach.
- A 3% systemic risk buffer (SyRB) applicable to a subset of three credit institutions, all of which are IRB credit institutions.
- A 1% countercyclical buffer (CCyB). The buffer rate will be increased to 2% as of 22 June 2023, thereby reaching the 2% neutral level for the CCyB set out by Finansinspektionen.
- A risk weight floor of 25% on retail exposures to obligors residing in Sweden secured by immovable property applicable to IRB credit institutions. The measure was introduced in December 2018, and was extended in 2021 until 31 December 2023.

According to Finansinspektionen, the proposed measure aims to increase and strengthen resilience in the Swedish banking sector given the risks in the CRE sector. By introducing the risk weight floor within the framework of Article 458 of the CRR, the already built-up capital, through the current Pillar 2 requirement, will remain in place in order to be available to address and manage potential future credit losses in the CRE sector.

Section 2: Analysis of the underlying systemic risks

In the beginning of 2023, the ESRB acknowledged the importance of the CRE sector due to the sector's size and because it is closely interconnected with both the financial system and the real economy.[5] In Sweden, the banking sector has large exposures to the CRE sector, and CRE firms constitute the banks' largest group of borrowers among non-financial corporates (NFC). Roughly 50% of the major credit institution's loans to

[5] See ESRB report "**Vulnerabilities in the EEA commercial real estate sector**", January 2023.

NFCs goes to CRE firms. Furthermore, in the last ten years, financing via the capital market increased from around 10% to 35% of the listed CRE firm loans. Thus, the Swedish CRE sector is increasingly interconnected with the real and financial sector, with potential disturbances easily spreading to and within the financial system.

With CRE prices growing rapidly until 2022 (albeit moderating recently), and increased levels of debt in the sector, adverse developments in CRE could have a systemic impact on the financial system and real economy. For a long period, the Swedish economy experienced very low interest rates and high economic growth, providing for a strong demand in the CRE market. CRE firms increased borrowings to finance property acquisitions and project investments, with debt-to-income ratios rising rapidly, particularly within the last three years. Large debts with low interest rates make CRE firms sensitive to disturbances such as changed financing conditions or a worsened economic situation. There have been sharply rising interest rates experienced in Sweden since the summer of 2021, therefore refinancing in the sector has become more difficult and more expensive. To reduce their debt, during stressed market conditions, firms may sell properties, adding further downward pressure on prices. A general fall in property prices would weaken the financial ratios of other CRE firms and could lead to credit institutions becoming cautious in their CRE lending. In addition, CRE stress can have negative spillover effects on the real economy, through its impact on investments in the economy and particularly the construction sector.

As identified by the ESRB and Finansinspektionen, other vulnerabilities for CRE relate to structural changes. These include the impact of climate-related policies, a shift towards e-commerce and increasing demand for flexibility in leasable office space on the CRE market. Some of these changes and developments have accelerated as a result of the coronavirus (COVID-19) pandemic and Russia’s invasion of Ukraine. These vulnerabilities could give rise to credit losses in Swedish credit institutions as they are highly exposed to the CRE sector. A risk weight floor for CRE exposures would ensure that the credit institutions hold enough capital for the loss risk specific to CRE lending, which is crucial for financial stability.

3.1 How the measure addresses the identified risk

The ESRB issued a dedicated European Economic Area (EEA)-wide recommendation setting out policy measures for credit institutions to adopt in the short to medium-term to address CRE vulnerabilities.[6] To increase the resilience of the banking sector, authorities may use risk weight measures or capital buffers: these measures can be used either to address broad cyclical or structural risks, or to target CRE-specific risks. More specifically, risk weight measures are considered suitable in a scenario of varying or continuously declining risk weights. The proposed measure can deal with the varying risk weights for CRE loans that comes with the gradual implementation of changed internal models following the on-going IRB reviews.

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[6] See “**ESRB Recommendation on vulnerabilities in the commercial real estate sector in the European Economic Area**”, December 2022.

The proposed measure aims to increase resilience in the financial system in relation to the systemic risk that is connected to the CRE sector in Sweden. The CRE sector in Sweden is highly indebted and credit institutions' exposure to the sector is large. Many CRE firms are vulnerable to shocks or a deterioration in the macroeconomic conditions and so problems in the sector could give rise to vulnerabilities in credit institutions. The proposed measure ensures that credit institutions hold enough capital to cover the loss risk for corporate exposures secured by commercial and residential properties. This makes them more resilient to potential economic downturns and ensures that they maintain the supply of credit to the real economy.

The proposed measure is considered proportionate and effective as it specifically targets IRB credit institutions' corporate exposures secured by commercial and RRE from which systemic risk may emerge. The measure increases the risk weights on Swedish CRE exposures, from a current level of 17% (volume-weighted) to at least 35% for commercial properties and from a current level of 13% to at least 25% for residential properties. Thus, the risk weight floors increase the capital levels and creates an added loss-absorbing capacity in the affected credit institutions. The additional capital requirement, in nominal terms, corresponding to the enforcement of the proposed risk weights floors is expected to be SEK 18 billion at the consolidated level (data from Q4 2022) or around a 4% additional capital requirement for the largest credit institutions in Sweden. It is considered that this increases resilience without unduly affecting the supply of credit to CRE firms. In addition to targeting specific exposures, the possibility for reciprocation increases the effectiveness of the measure if it is applied to foreign branches and direct foreign exposures.

The proposed measure replaces an existing Pillar 2 capital add-on for IRB banks. The existing Pillar 2 measure corresponds to a 35% and 25% average risk weight for certain corporate exposures secured by commercial and RRE, respectively, in Sweden. The additional impact on total capital requirements due to the proposed measure under Article 458 of the CRR is expected to be limited since the measure will replace a corresponding capital requirement in Pillar 2. Finansinspektionen rather expects the new measure to maintain the current level.

The ESRB is of the view that while the measure affects only a limited number of credit institutions, these credit institutions have large market share and ensuring their resilience to risks from CRE exposures is of systemic importance in Sweden. Furthermore, from a forward-looking perspective, it prevents a further decline of risk weights for the CRE portfolio, thus acting as a backstop.

3.2 How the measure relates to possible alternatives

a) Increasing the risk weights for credit institutions applying the standardised approach to credit risk (Article 124 of the CRR)

Relevant authorities can impose higher risk weights for exposures secured by mortgages on credit institutions that apply the standardised approach on the basis of financial stability considerations. Relevant authorities can set a risk weight for exposures secured by mortgages on residential immovable property from 35% to up to 150%. In addition, they can apply stricter criteria for the application of the 35% risk weight.

Article 124 of the CRR would not be effective in meeting the proposed measure's objectives, given the vast majority of the Swedish CRE exposures are held by IRB credit institutions. Moreover, the risk weight for credit institutions using the standardised approach is considerably higher than those of IRB credit institutions (50%), and is considered sufficiently high by Finansinspektionen in relation to systemic risk

b) Increasing exposure-weighted average loss given default (LGD) for all retail exposures secured by residential property for credit institutions applying the IRB approach to credit risk (Article 164 of the CRR)

Relevant authorities can set higher minimum values of exposure-weighted average loss given default (LGD) for exposures secured by immovable property on the basis of financial stability considerations. The exposure-weighted average LGD for all retail exposures secured by residential property and not benefiting from guarantees from central governments must not be lower than 10% and authorities may increase this limit.[7] LGD is one of the parameters used in the risk weight function. Increasing the LGD indirectly increases the risk weights and the resulting capital requirements. However, Article 164 of the CRR is not applicable to corporate exposures and hence not possible to use for the exposures in question.

c) Using the systemic risk buffer (Article 133 of the CRD)

Member States may introduce a SyRB to prevent and mitigate systemic or macroprudential risks not covered by the CRR or by Articles 130 and 131 of the CRD. The SyRB can be applied to all credit institutions or to a subset of credit institutions. Furthermore, the SyRB can be applied to all, sectoral or subsets of sectoral domestic exposures, exposures in third countries and all or sectoral exposures in other Member States.

A SyRB would impact all or all domestic exposures even for a subset of credit institutions. The aim of the risk weight floor is to safeguard the sufficiency of the capitalisation of the credit institutions using internal risk models against risks stemming from CRE exposures. Using a SyRB applicable to all or all domestic exposures would have sizeable side effects, impacting retail exposures, and would not achieve the desired goal of increasing resilience towards corporate exposures to CRE as proportionally and efficiently as the proposed risk-weight floor measure.

A sectoral SyRB would be less effective and efficient in addressing the systemic risk identified than the proposed measure, given that its effects could be mitigated by declining and, from a macroprudential perspective, inappropriately low IRB risk weights for CRE exposures. A sectoral SyRB applied solely to corporate exposures secured by CRE would not be as efficient in achieving the desired outcome of establishing a floor to prevent a further decline in risk weights. It would need to be set at a relatively high level to achieve the equivalent impact of the existing measure. According to Finansinspektionen, in order to replace the current floor measure, the applicable buffer rate would vary between credit institutions and would have to be set between 20% – 40% when it comes to exposures secured by CRE and 10% – 25 % for RRE. Furthermore, the three largest

[7] Article 164(4) of the CRR.

credit institutions in Sweden have varying risk weights for their CRE exposures. A review of all credit institutions' internal models is on-going, and may result in a change in the variation at different points in time depending on when the individual review is complete. Until all reviews are finalised, it would be inappropriate to determine a sectoral SyRB as the degree to which additional resilience is needed might change. This situation may change in the medium-term once the on-going review of the internal models is complete and when the unwarranted heterogeneity in risk weights is fully eliminated. Finally, a single rate sectoral SyRB would impact IRB credit institutions with the highest risk weights more so than those with the lowest risk weights. This is counterintuitive to the purpose of the proposed measures, which is to address low risk weights.

d) Using the countercyclical capital buffer (Article 136 of the CRD)

The CCyB addresses some of the procyclicality in the financial system and is a requirement applicable to domestic exposures. The rate for the CCyB is assessed on a quarterly basis by the designated authority, who follow a specific methodology based on an ESRB recommendation.[8]

Finansinspektionen considers that the CCyB is not an appropriate tool to address sectoral systemic risk, as it would apply to all exposures in Sweden and not only to Swedish CRE exposures. The CCyB rate is applied as a percentage of the total amount of risk exposure and can therefore not be applied to specific subsets of exposures. Addressing the risk via a CCyB would lead to similar side effects mentioned above for the SyRB applicable to all/all domestic exposures.

e) Using other measures

The proposed measure replaces an existing Pillar 2 capital add-on for IRB credit institutions. Taking into consideration the increasing systemic relevance of CRE exposures, in addition to the varying risk weights that will prevail while the IRB model reviews are on-going, Finansinspektionen considers a macroprudential measure to address the vulnerabilities identified as more appropriate. Even when risk weights are assessed and stabilised, applying a Pillar 2 capital add-on can only be conducted on an annual basis via the SREP review and Pillar 2 add-ons should not be used to address the macroprudential dimension of systemic risk. This, combined with the clear systemic risk implications of the vulnerability identified, points to the necessity for a macroprudential tool.

Section 4: Analysis of the net benefits of the measure

4.1 Effects on financial stability, financial system resilience and economic growth

The proposed measure for Swedish corporate exposures secured by commercial or residential properties constitutes an important element of the capital requirements for Swedish banks for financial stability

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[8] Recommendation of the European Systemic Risk Board of 18 June 2014 on guidance for setting countercyclical buffer rates (ESRB/2014/1) (OJ C 293, 2.9.2014, p.1).

purposes. It aims to tackle the elevated systemic risks connected to the real estate sector in Sweden, increasing the stability of the Swedish financial sector as credit institutions will be required to hold own funds proportionate to the risks in the Swedish commercial real estate sector.

The proposed measure will contribute to the resilience of the Swedish banking system via replacing the existing Pillar 2 requirement and therefore enhancing the resilience of the economy as a whole. The additional capital requirement in the banking system due to current capital add-ons in Pillar 2 amounts to SEK 17 billion (around 4% of the existing capital requirement for the largest Swedish credit institutions at the consolidated level. The proposed measure has largely the same impact and is expected to generate SEK 18 billion in additional capital requirement based on Q4 2022 figures (including the impact of Pillar 2 Guidance). The measure adds both minimum and loss-absorbing capital that strengthens the resilience in the banking sector against negative developments in the CRE market or shocks to the macroeconomy at large.

According to Finansinspektionen the proposed measure is not expected to have a material unintended impact on the general economy. The evaluation of the current Pillar 2 requirement showed limited impact on IRB credit institution's interest margins on loans to CRE firms. Furthermore, there were no signs of credit institutions increasing risks to maintain profitability (a concern when the floor was originally introduced via Pillar 2). CRE firms' borrowing has continued to grow since Finansinspektionen introduced the measure and there are no signs of changes in credit institutions' credit supply to CRE firms or CRE firms' demand for credit.

4.2 Effects on both domestic and cross-border lending

Finansinspektionen expects a limited impact on domestic lending given the proposed measure replaces an existing Pillar 2 requirement. The current Pillar 2-measures had little effect on credit institutions' interest margins on loans to CRE firms, with no increase in risk taking to maintain profitability or decrease in CRE firms' demand for credit.

Developments in CRE borrowing from the capital market should be monitored. Despite there being no clear link between the growth in market lending and the introduction of the Pillar 2 requirement, it would be prudent to monitor developments in this space and the impact on bank lending. If growth trends outside the banking sector were to increase, it would be necessary to reflect on the effectiveness of the proposed measure.

Any potential outward spillover effects in other countries is expected to be positive. Since the proposed measure supports the resilience of the Swedish banking sector, Swedish credit institutions operating cross-border will be in a stronger position to continue lending to the real economy in those countries, supporting financial and economic stability. The same could be said if the proposed measure is reciprocated as it may increase the loss-absorbing capacity of institutions related to Swedish CRE exposures in other countries. As mentioned previously, a more detailed assessment of the reciprocation request will be conducted separately by the ESRB.

Finansinspektionen assesses that the proposed measure will have a positive impact on the internal market. The positive consequences are the direct result of the financial stability benefits in terms of reducing and mitigating the macroprudential or systemic risk identified. This is increasingly important in the context of the

financial interlinkages in the Nordic-Baltic region and the enhanced cross-border dimension of the Swedish financial sector.

4.3 Effects on intragroup behaviour of credit institutions

All significant lenders in the Swedish CRE sector are consolidated in Sweden, except for the Swedish branches of two institutions. Reciprocity in the application of the proposed measure is therefore considered important so as to avoid leakages and regulatory arbitrage. In this context, Finansinspektionen emphasises that a Memorandum of Understanding on prudential supervision of significant branches applies to the Nordic-Baltic macroprudential network. The competent authorities in the region acknowledge the importance of reciprocity of macroprudential measures in general, and in particular as a means to prevent banks from circumventing the measures by transferring operations to other countries.

Conclusions

The CRE sector is important for financial stability in Sweden given its size and interconnections. The CRE sector poses large risks for the Swedish financial sector given its size, its cyclically sensitivity, and close connection to the financial system. Indebtedness in the sector is high (CRE firms debts make up roughly 35% of Swedish gross domestic product (GDP)) and Swedish credit institutions have significant exposures to it. Payment problems and insolvencies in CRE firms could entail sizeable credit losses for credit institutions, thus impacting financial stability. More specifically, the ESRB identified that in Sweden, as of mid-2022, the investment volume in CRE over the past four quarters comfortably surpassed 1% of GDP and the country had the highest volumes across all EEA countries for which data were available. In addition, the sector is important amongst financial market actors, including investment funds, insurance undertakings, pension funds and credit institutions.

According to Finansinspektionen, the main purpose of the proposed measure is to address systemic risks stemming from vulnerabilities related to corporate exposures to the CRE sector. Sufficiently high risk weights should support the resilience of credit institutions and ensure that they hold sufficient own funds to cover the materialisation of systemic risks related to CRE. However, the vulnerabilities from CRE can be amplified by spillovers across countries and through interlinkages between financial institutions, as cross-border investment flows and credit exposures to other countries are much stronger in the CRE than in the RRE sector. Therefore, the consideration of the reciprocation request for this proposed measure will be an important element to its successful implementation.

The ESRB recently identified a number of vulnerabilities in the EEA CRE sector, issuing a recommendation setting out policy measures aimed at, in part, increasing the resilience of financial institutions against the potential materialisation of these risks. The ESRB determined that risk weight measures would be suitable in a scenario of varying or continuously declining risk weights for CRE loans. To increase the resilience of the banking sector, authorities may use risk weight measures or capital buffers and these measures can be used either to address broad cyclical or structural risks, or to target CRE-specific risks.

Overall, the ESRB considers that the proposed measure may help to maintain resilience in IRB credit institutions in Sweden so as to mitigate a possible materialisation of systemic risk in the CRE market. While CRE systemic risk in Sweden has increased over recent years, the measure is aimed at ensuring that credit institutions hold sufficient own funds to cover systemic risks should they materialise.

Furthermore, the ESRB is of the view that the alternative macroprudential instruments listed in Article 458 of the CRR would be less suitable and effective to address the risk at hand. Measures such as those listed under Articles 124 and 164 of the CRR, as well as the systemic risk buffer or the countercyclical capital buffer, are considered to be inappropriate or not sufficiently efficient since they do not provide the intended incentives, are too broad-based, may impact credit institutions in a disproportionate manner or be administratively burdensome to operate. Furthermore, they do not address the relevant type of risk, exposure or credit institution in a timely manner.

Finally, the ESRB is of the opinion that the use of the proposed measure would not entail disproportionate adverse effects for the internal market or the financial systems of other Member States. The measure would ensure a level of risk weights commensurate with the systemic risk and prevent a potential decline in risk weights applied by IRB credit institutions to the portfolio of CRE loans. Also, as the average applicable risk weight on CRE loans of credit institutions in other countries in the region is generally either higher or close to the proposed floors, this should not have a disproportionate adverse effect on the internal market.