18 February 2016

Assessment of the notification by Belgium in accordance with Article 458(9) of Regulation (EU) No 575/2013 concerning the extension of a stricter national measure for residential mortgage lending

Introduction

In a letter dated 2 November 2015, the Nationale Bank van België/Banque Nationale de Belgique (NBB) notified the Chair of the Advisory Technical Committee (ATC) of the European Systemic Review Board (ESRB) of the NBB's intention to extend for another year its stricter national measure for residential mortgage lending under Article 458 of the Capital Requirements Regulation (CRR)[1].

This stricter national measure consists of a 5 percentage point add-on to the risk weights relevant to Belgian mortgage loan exposures of banks that apply the internal ratings-based (IRB) approach for calculating regulatory capital requirements. The measure applies to both the stock of existing loans and the flow of new loans. The measure was adopted under Article 458 of the CRR, which requires that the ESRB, the European Banking Authority (EBA), the European Commission and the Council of the EU are involved in the process.

In its opinion of 30 April 2014[2], the ESRB expressed the view that the measure was justified, suitable, proportionate, effective and efficient. Moreover, the measure was seen as not having a negative impact on the internal market that outweighs its financial stability benefits. On 28 May 2014, and taking into account the opinions of the ESRB and EBA, the Commission decided not to propose to the Council of the EU an implementing act to reject the draft measure. The authorisation of the measure is valid for two years, that is, until 28 May 2016.

The extension of a stricter national measure under Article 458 of the CRR, which may only be granted for one additional year at a time, is governed by paragraph 9 of the article. This paragraph provides for consultation between the relevant Member State, the ESRB and the EBA to review the situation. This consultation process was initiated by the letter from the NBB dated 2 November 2015, referred to above. The extension is subject to the procedure described in paragraph 4 of Article 458 of the CRR (that is, the same procedure which applies to the initial adoption of the measure).

On 21 January 2016, the ESRB received official notification from Belgium of the planned extension of the measure, initiating the extension procedure. The ESRB is required to provide the Council of the EU, the Commission and Belgium with an opinion within one month of receiving such notification (that is, by 21 February 2016). The opinion must be accompanied by an assessment of the planned extension, which addresses the points specified in paragraph 2 of Article 458 of the CRR. This document provides the required assessment. It focuses in particular on factors which have changed since the initial assessment that accompanied the

[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 176/1, 27.6.2013, p.1).

[2] http://www.esrb.europa.eu/pub/pdf/other/140430_ESRB_Opinion-on-Belgian-measure.pdf?ed91f0d84850e4c4975611d7b8b9d892

ESRB opinion of 30 April 2014[3], and is therefore usefully read in conjunction with that earlier assessment.

1. Analysis of the underlying systemic risks

In its assessment of the relevant underlying systemic risks, the ESRB relies to a large extent on information and data provided by the NBB. Together with the assessment that accompanied the ESRB opinion of 30 April 2014, the following points should be noted:

a) Vulnerabilities in the property sector

- **Residential property prices.** Growth rates of nominal residential property prices in Belgium have declined markedly since 2011 (and on average by 0.6% in 2014), while in real terms, prices have been broadly stable. Preliminary figures for 2015 indicate a pick-up[4], although data quality issues need to be taken into consideration. Nominal prices are projected to increase by 3.5% in 2015 and 2016, and by 2.6% in 2017.
- **Transaction volumes.** Transaction volumes are stable, or show a small decline since 2011. They peaked in the fourth quarter of 2014, but this was due to anticipation effects in response to reduced tax deductibility of mortgage loans as from January 2015. Preliminary data for 2015 are not yet available.
- **Valuation indicators**. Valuation indicators do not provide unambiguous signals pointing to an overvaluation of the residential property markets. Based on preliminary data for 2015, the NBB model-based indicator signals an increase in overvaluation of around 8%. Apart from data quality considerations, valuation indicators are also affected by the very low interest rate environment and changes in tax treatment of mortgage loans.

b) Vulnerabilities in the household sector

- **Household indebtedness.** Over the past years, household indebtedness has increased in Belgium because of the rise in mortgage debt. As a result, household debt levels are now close to the euro area average (59% of GDP, compared to the euro area average of 61%). This has raised some concerns about debt sustainability, especially for the segment of young and low income households.
- **Household net wealth.** In spite of rising debt levels, household net wealth (debt as against assets) has remained relatively stable. This is due to the substantial increase in the value of households' financial assets and to their high savings rate. However, because of the mismatch between the distribution of mortgage debt and of financial assets, the high stock of financial wealth does not enhance the debt sustainability of a substantial proportion of households.
- **Vulnerability to an interest rate shock.** Over the past two years, a shift in the composition of the mortgage loan portfolio towards loans at fixed and lower interest rates can be observed, driven by refinancing activity and by the very low interest rate environment. The mortgage credit law also limits the maximum interest rate variability that can be passed on to borrowers. The vulnerability of households to an interest rate shock therefore remains limited.

[3] http://www.esrb.europa.eu/pub/pdf/other/140430_ESRB-Opinion-on-Belgian-measure_Report.pdf?e8720d406af2a2ba092ea703a7933503

[4] Nominal prices showed an average growth rate of 0.4% over the first three quarters of 2015 and have been flat in real terms.

- **Vulnerability to an unemployment shock.** As highlighted in several NBB publications[5], households (especially those in the young and low-income household segment) remain vulnerable to a severe unemployment shock that would affect their income and debt repayment capacity. Mortgage indebted households hold on average less (liquid) financial assets than households without mortgage debt[6]. Hence, the high stock of financial wealth in Belgium does not enhance the sustainability of mortgage debt for a significant proportion of households under the scenario of a severe unemployment shock.

c) Vulnerabilities in the banking sector

- **Solvency position.** Belgian banks have a relatively sound solvency position. Their Common Equity Tier 1 ratio increased from 11.3% at the end of 2008 to 15.6% at the end of the third quarter of 2015[7]. The measure discussed in this assessment further increases the resilience of the Belgian banking sector, although the additional capital buffer is relatively small[8]. Under the ECB's comprehensive assessment carried out in 2014, the Belgian banks included in the stress test were subject to a specific real estate shock scenario, in addition to the depressed macroeconomic scenario. The capital buffer following the macroprudential capital add-on measure would cover around 60% of the expected and unexpected losses under this scenario[9].

- **Size and quality of the mortgage loan portfolio.** The mortgage loan portfolio of Belgian banks has increased further in 2014 and 2015, driven by the very low interest rate environment and the anticipation of changes in tax treatment of mortgage loans. The evolution of non-performing mortgage loans and cumulative defaults on mortgage loans over the past two years has remained broadly stable[10].

- **Credit standards.** Some tightening of credit standards by Belgian banks can be observed. However, this is at least partly influenced by the substantial refinancing activity in the very low interest rate environment. Refinanced mortgages are generally characterised by shorter maturities, lower debt service-to-income (DSTI) ratios and lower loan-to-value (LTV) ratios. Banks have also progressively increased their commercial margins on new loans despite increasingly intense competition. On an aggregate basis there remain pockets of vulnerability in the mortgage loan portfolio of Belgian banks, as reflected in the significant (albeit lower than before the entry into force of the measure) proportion of high-DSTI and high-LTV loans in the new production of mortgage loans[11] (although these are lower than before the measure entered into force). The significance of these pockets of risk varies from bank to bank.

- **Calibration of internal models.** Reviews by the NBB of the internal models of Belgian banks did not raise general concerns about the adequacy of those models for mortgage loans. The comparatively low risk weights calculated by banks that apply the IRB approach reflect the

[5] See "Macroeconomic determinants of non-performing loans", *Economic Review*, National Bank of Belgium, Brussels, December 2015 and "Structure and distribution of household wealth: An analysis based on the HFCS", *Economic Review*, National Bank of Belgium, Brussels, September 2013.
[6] Almost one-third of the total amount of outstanding mortgage debt of Belgian households is held by households able to service their mortgage debt out of liquid financial assets for less than six months, while almost one-half is held by households owning liquid financial assets worth less than 10% of their outstanding mortgage debt.
[7] The CET1 ratio (phase-in) was 15.6% at the end of the third quarter of 2015.
[8] EUR 617 million or 1.2 % of current CET1 capital of the banks concerned.
[9] It is important to highlight that the sample covered by the stress test exercise does not include ING Belgium or BNP Fortis which together represent more than 40% of the market.
[10] The average default rate of mortgage loans was 1.7% in 2014.
[11] Loans with a DSTI greater than 50% accounted for 20% of the total new production in 2014 and in the first half of 2015. Loans with an LTV greater than 90% accounted for more than 30% of the most recent new production.

absence of any major residential real estate crisis in Belgium in recent decades[12], but where individual and specific weaknesses were observed in a bank's internal models, the bank concerned was requested to address them.

2. Effectiveness and efficiency of the measure

The measure was effective in its primary objective of further increasing the resilience of the Belgian banking sector, although the additional required capital buffer is in aggregate relatively small. The measure was further effective in signalling to the Belgian banking sector, and to the public at large, the growing financial stability concerns about developments in the residential real estate sector. Not to extend the measure would therefore dilute or bring an end to these effects. So far, the NBB has not observed any impact on other parts of the financial system, or on individuals or firms outside Belgium, that would erode the effectiveness and efficiency of the measure.

The ESRB's earlier assessment of how the measure relates to alternatives, which must be considered (before having recourse to Article 458 of the CRR to adopt a stricter national measure) still remains valid. The earlier assessment should therefore be referred to for further details. It is useful to recall that the other available measures specified in Article 458 of the CRR (some of which refer to the Capital Requirements Directive (CRD)[13]) include the following:

- increasing the risk weights for banks applying the standardised approach (Article 124 of the CRR);
- increasing the loss given default floor for IRB banks (Article 164 of the CRR);
- using the systemic risk buffer (Article 133 of the CRD);
- using the countercyclical capital buffer (Article 136 of the CRD);
- using Pillar II (Articles 101, 103, 104 and 105 of the CRD).

Since the earlier assessment, the competence to impose measures under Pillar II has shifted from the NBB to the ECB, as a result of the establishment of the Single Supervisory Mechanism (SSM). Therefore, when considering the assessment that accompanied the ESRB opinion dated 30 April 2014, the following additional points should be noted:

- First, the ECB has communicated to the NBB that under Article 5 of the SSM Regulation[14] the ECB does not object to the request to extend the measure.
- Second, the ECB recommends credit institutions should not publicly disclose their Pillar II requirements and the ECB does not itself provide a detailed quantification of the Pillar II requirements for each type of risk; hence, the signalling effect mentioned earlier, which was one of the main considerations for introducing the measure, would cease if a Pillar II measure were to be adopted.

[12] The average risk weight applied to mortgage loans by banks that apply the internal ratings-based (IRB) approach for calculating regulatory capital requirements (IRB banks) is around 10% (before the add-on). The models are calibrated on the basis of data covering the past five to ten years.

[13] Directive (EU) No 2013/36 of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (OJ L 176, 27.6.2013, p.338).

[14] Regulation (EU) No 1024/2013 of the European Parliament and of the Council of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).

- third, the ECB takes its Supervisory Review and Evaluation Process (SREP) decision once a year in the form of a requirement to apply a CET1 ratio that also affects other loans; hence using Pillar II would not be an efficient method of addressing the specific risk related to residential mortgage loans.

3. Net benefits analysis of the measure

The analysis above indicates that the residential real estate market in Belgium has stabilised somewhat over the recent period, but that there continues to be a risk of a decline in property prices. The analysis is complicated by the effect of the very low interest rate environment, the anticipation of changes in tax treatment of mortgage loans, the extensive refinancing activity, and concerns about the quality of the most recent data. Furthermore, while there are tentative signs that the quality of the portfolio of mortgage loans held by Belgian banks has improved and that lending standards have been tightened, there seem to remain pockets of vulnerability in the mortgage books of banks.

The NBB sees no indications that the introduction of the measure has led to significant changes in direct cross-border lending or lending through the Belgian branches of foreign banks. Direct cross-border mortgage lending is practically non-existent. The market share of foreign branches participating in mortgage lending has remained below 1% and there have been no significant new entrants in recent years. Moreover, the NBB has not observed any shift in mortgage loan portfolios from subsidiaries to branches of the same banking group (which can create the risk of regulatory arbitrage that was flagged in the ESRB's original assessment). However, if subsidiaries of EU banks were to be transformed into branches, the issue of reciprocity would become particularly relevant[15].

Belgium has requested that the ESRB recommend to other Member States that they recognise the measure. It should be noted that the measure has already been reciprocated by the Netherlands in the case of mortgage lending through branches of Dutch banks in Belgium, on the basis of Article 458, paragraph 5 of the CRR[16]. The request for general reciprocation is being considered by the ESRB through a parallel and ongoing process.

4. Conclusions

The ESRB considers that the arguments for introducing the measure still remain valid and that an extension of the measure for another year is therefore warranted. In particular, the continued presence of pockets of vulnerability in the mortgage portfolio of Belgian banks, as reflected by the proportion of high LTV and/or high DSTI loans, remains a concern. Not to extend the measure would also bring an end to its signalling effect and reduce the required capital buffer, thereby potentially reducing the resilience of the banks.

It would be helpful if the NBB could be more specific in clarifying the criteria it would apply in the future when deciding whether or not to prolong the measure, or to extend it further. This greater level of detail would assist the ESRB in any future further assessment, including concerning the reciprocation of the measure by other Member States.

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[15] At present 15 banks from six countries each have a subsidiary in Belgium. Some of these subsidiaries have a significant share of the Belgian banking market.

[16] http://www.esrb.europa.eu/pub/pdf/other/150107_DNB_notification_of_Belgium_reciprocity.pdf?55ca15afd7775f2100a9baf913f3b459.

Finally, the cyclical and portfolio-specific nature of the risk warrants close and continued monitoring of its evolution over time.