ESRB European Systemic Risk Board European System of Financial Supervision

EUROPEAN CENTRAL BANK EUROSYSTEM

EBA EUROPEAN BANKING AUTHORITY

Template for notifying intended measures to be taken under Article 458 of the Capital Requirements Regulation (CRR)

Please send this template to

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1. Notifying national authority and scope of the notification	
1.1 Name of the notifying authority	Eesti Pank
1.2 Categorisation of measures	The measure will be taken in relation to Article 458(2)(d)(vi) of Regulation (EU) No 575/2013.
1.3 Request to extend the period of application of existing measures for one additional year **(Article 458(9) of the CRR)**	Not applicable.
1.4 Notification of measures to which Article 458(10) of the CRR applies ('notification only procedure')	Not applicable.
2. Description of the measure	
2.1 Draft national measures **(Article 458(2)(d) of the CRR)**	The proposed measure is a credit institution-specific minimum level of 15% for the exposure-weighted average of the risk weights applied to the portfolio of retail exposures secured by mortgages on immovable property to obligors residing in Estonia. The measure applies to credit institutions that use the IRB Approach for calculating regulatory capital requirements.
2.2 Scope of the measure **(Article 458(2)(d) of the CRR)**	• The measure applies to retail exposures secured by mortgages on immovable property to obligors residing in Estonia. The calculation of the average risk weight at the portfolio level will be based on reported data in the COREP template C 09.02 – Geographical breakdown of exposures by residence of the obligor: IRB

	exposures (CR GB 2), Estonia, and the relevant cells are: row 070, and columns 105 and 125. • The measure applies to credit institutions that have adopted the IRB Approach. The measure applies on an individual and consolidated basis.
2.3 Calibration of the measure	The calibration of the proposed measure is based on an assessment of credit losses from housing loans under a stress scenario. Eesti Pank carried out a simulation where a macroeconomic shock similar to that which affected Estonia in 2008-2009 in reaction to the global financial crisis was assumed (i.e. fall in real GDP cumulatively by 20%, decrease in housing prices by 50%, increase of unemployment to 20%). The credit risk model of Eesti Pank shows that the loan loss ratio for housing loans would increase to 1.4% in reaction to the shock. Applying the model result to the size of the residential mortgage exposure and considering the minimum requirement for capital would give an estimated minimum level for the average risk weight for residential mortgage loans of 16%. However, the confidence interval for such an assessment is quite wide, showing that the minimum risk weight may fall in a range between 10% and 25%. Given the current economic environment, Eesti Pank finds it appropriate to set the minimum level of the exposure-weighted average risk weight for residential mortgage loans at 15% as a precautionary measure for safeguarding banking sector resilience against risks related to residential mortgages. The calibration was set at 15% level, because the objective of the measure is to establish a floor to limit further decrease in risk weights.
2.4 Suitability, effectiveness and proportionality of the measure **(Article 458(2)(e) of the CRR)**	The measure is intended to limit any further decrease in risk weights. The risks from lending for residential real estate have not diminished in recent years and yet the risk weights for residential mortgage loans have been declining. The intention in setting an average risk weight floor is to uphold the resilience of the banks and to ensure that they hold sufficient own funds to cover systemic risks related to mortgage loans and the residential real estate market. The direct negative spillovers from the proposed measure are limited as it would only apply to retail exposures secured by real estate property. Hence the measure would not significantly affect the other activities of banks, such as corporate financing. The measure will help to ensure that macroprudential buffers such as the systemic risk buffer, the O-SII buffer and the countercyclical capital buffer are effective. If the risk weights were to decline further, the buffers would become less effective. This could mean the established buffers would be insufficient if the systemic risk materialised. The measure aims to ensure a level playing field in the Estonian market. Setting an exposure-weighted average risk weight floor for IRB banks limits any unjustified increase in the differences in risk weights between the IRB banks themselves and between the IRB and SA banks. Above all, the housing loan portfolios of the IRB banks in Estonia are similar and do not justify significant differences in the average risk weights. Nevertheless, the IRB banks would still have sufficient flexibility to apply lower risk weights to suit the risk profiles of individual loans.

	Applying the measure will increase the aggregate risk exposure of the IRB banks by 140 million euros or 2.2%. The estimated impact on the weighted average CET1 ratio of the IRB banks is approximately 0.8 percentage points. Since both Estonian IRB banks hold capital buffers well above the required level as their weighted average CET1 ratio was 39.2% at the end of 2018, neither of them is expected to need to raise new capital to meet the additional capital requirement. However, the average risk weight varies between the banks, and so the measure will impact the capital ratios of the banks differently. The impact of the measure on loan margins, loan growth and economic growth is expected to be small.
2.5 Other relevant information	From March 2015 three requirements have applied for credit institutions when they issue housing loans: an LTV limit of 85%, a DSTI limit of 50%, and a maximum maturity for housing loans of 30 years. All credit institutions are required to hold a Systemic Risk Buffer (SyRB) of 1% of domestic exposures. On top of the SyRB, the O-SII buffer requirements apply to systemically important credit institutions. The two IRB banks are both subject to an O-SII buffer requirement of 2%.
3. Timing of the measure	
3.1 Timing of the Decision	15 April 2019
3.2 Timing of the Publication	Q3 2019
3.3 Disclosure	The measure together with the justification for it will be published on the Eesti Pank website. The decree of the Governor of Eesti Pank will be published in Riigi Teataja, which is the official gazette of the Republic of Estonia.
3.4 Timing of Application (Article 458(4) of the CRR)	Q3 2019
3.5 Phasing in	No phasing-in is planned.
3.6 Term of the measure (Article 458(4) of the CRR)	The measure is intended to apply for two years and it may then be renewed afterwards.

3.7 Review **(Article 458(9) of the CRR)**	The measure will be reviewed within two years after application.
4. Reason for the activation of the stricter national measure	
4.1 Description of the macro-prudential or systemic risk in the financial system **(Article 458(2)(a) of the CRR)**	The risk-weights for mortgage loans calculated using internal models have declined in recent years, while **the level of risks stemming from the macroeconomic environment and from the residential real estate market in particular has not decreased.** Over the last five years the exposure-weighted average risk weight on retail exposures in Estonia secured by immovable property has declined from 17.8% to 13.4%. In addition, the observed risk weights are relatively heterogeneous at the two IRB banks as the average risk weight at one IRB bank was 1.8 times larger than that at the other at the end of 2018. The falling risk weights on mortgage loans reflect a prevailing period of favourable economic circumstances, during which there has been a decrease in overdue loans. At the same time neither bank lending dynamics, residential real estate market developments nor business cycle indicators point towards a decrease in the level of cyclical risks. During the past three years, the annual growth of residential real estate prices was 5.2% on average and that of housing loans was 6.5%. Even though the growth of residential real estate prices has slowed since the second half of 2018 and new housing loans have been growing at a slower pace than previously, there is a risk that the low unemployment rate and rapid growth in wages may push real estate prices to rise faster. With interest rates at a low level, this would accelerate the growth in housing loans. The indebtedness of Estonian households is below the average for the member states of the European Union. However, due to the greater volatility in incomes there is a danger that the related risks may be underestimated. The largest part of household debt liabilities is housing loans, the yearly growth rate of which was 7% in 2018. This is more than twice the average growth of housing loans in the euro area. Despite the rapid growth in debt liabilities, there has been no rise in household indebtedness. The rapid growth in incomes and GDP has ensured that the ratio of household debt to disposable income has remained at 71%, and the ratio of debt to GDP was close to 39% at the end of the third quarter of 2018. The volatility in the real growth in Estonian GDP has been much higher than that in the euro area as a whole. This increases the risks to debt sustainability, especially at times when the economy is running at above its potential level and the probability of a sharp drop in growth or even of a recession is larger than in previous years. **The exposure of the Estonian banking sector to residential real estate risks is high.** In 2018 housing loans accounted for 41% of the real sector lending portfolio, 29% of banking sector assets, and 29% of GDP. Housing loans measured as a share of GDP are 8 pp lower than a decade ago, but their share in the real sector lending portfolio of the banks has increased by 5 pp during the same period. The share of housing loans in the total loan portfolio of the banks in Estonia is approximately 1.5 times larger than the European Union average, and moreover, housing loans are almost twice

	the EU average as a share of the total assets of the banks[1]. Having such a large share of housing loans in the total loan portfolio and total assets of the banks highlights the sensitivity of banks to negative developments in the residential real estate market. **The large share that the IRB banks hold in the housing loan market means that should the related systemic risks materialise, the impact on the capacity of the banking sector for lending would to a large extent depend on the resilience of individual large banks.** Banks are the main providers of housing loans in Estonia and the market is dominated by a few large players. At the end of 2018 the two IRB banks had 75% of the total housing loan market, meaning their share was 4 pp higher than it was five years ago. Their share in new housing loans was even higher at 80% in 2018. This reflects the crucial role played by the IRB banks in the supply of housing loans to households.
4.2 Analysis of the serious negative consequences or threat to financial stability **(Article 458(2)(b) of the CRR)**	Residential mortgage loans are a large share of the total exposure of the Estonian banking sector. This means that if the banks have underestimated the systemic risks related to lending for residential real estate, their capital buffers may be insufficient to withstand the potentially large loan losses that could follow a severe downturn in the real economy or in the real estate market. Given the high degree of dependence of households and NFCs on financing by banks and the high level of concentration of the banking sector, it is essential that the capital buffers be sufficient to ensure a smooth supply of credit under negative macroeconomic scenarios too.
4.3 Indicators prompting use of the measure	The main indicators are: • The risk weights of retail exposures secured by mortgages on immovable property • The share of housing loans in the total lending and in the total assets of the banking sector • Concentration in the housing loan market and the share of the IRB banks' exposures • Housing loan growth and household indebtedness • Housing prices and indicators for price valuation
4.4 Justification why the stricter national measure is necessary **(Article 458(2)(c) of the CRR)**	The risk weights for mortgage loans calculated using internal models have declined in recent years, while the level of risks stemming from the macroeconomic environment and from the residential real estate market in particular has not decreased. The aim of the proposed measure is to safeguard the banking sector from the systemic risks that are related to residential mortgage loans. Prolonged favourable economic conditions have allowed credit institutions that use internal risk models to reduce their model-implied risk weights and consequently their capital requirements to safeguard them against the systemic risks that arise from the residential mortgage loans. At the same time the large market share of the IRB banks makes it especially important that they be sufficiently capitalised to

[1] The big gap to the euro area average arises partly because the portfolio of loans to the private sector makes up a relatively large part of the assets of the Estonian banking sector, while the share of debt securities is very small.

	withstand the impacts of potential downturn scenarios. Before considering macroprudential measures under Article 458 of Regulation (EU) No 575/2013, Eesti Pank consulted with the European Central Bank, which is the competent authority for the two IRB banks in Estonia, about possible microprudential supervisory steps to address the decrease observed in the exposure-weighted average risk weight for residential mortgage loans. **Article 124** of Regulation (EU) No 575/2013 allows the competent authorities to set higher risk weights for exposures secured by mortgages on immovable property where the standardised approach is used for calculating the own funds requirements for credit risk. Eesti Pank is intending to set a risk weight floor for mortgage loans for credit institutions that use the IRB approach. The risk weights currently applied under the IRB approach are significantly lower than the minimum rate of 35% used by credit institutions that apply the standardised approach. **Article 164** of Regulation (EU) No 575/2013 allows the competent authorities to set a higher minimum level for the exposure-weighted average loss given default (LGD) rates for retail exposures secured by immovable property. Under this article the exposure-weighted average LGD for retail exposures secured by residential property and not benefiting from guarantees from central governments may not be lower than 10%. Eesti Pank is not entitled to apply any measures under this article as the article extends such powers only to the competent authorities. When assessing how appropriate this measure may be, it must be remembered that the lower risk weights for mortgage loans in Estonia have been the result of a fall in the PD rather than in the LGD estimates. The average LGD rates have fallen by less and are more homogenous across banks. **Article 101** of Directive 2013/36/EU obliges the competent authorities to review and assess whether credit institutions are using well developed and up-to-date techniques and practices for internal approaches. Where material deficiencies are identified in the risk capture of an institution's internal approach, the competent authorities must take appropriate steps to mitigate the consequences of this, which may include imposing higher multiplication factors or capital add-ons, or taking other appropriate and effective measures. Eesti Pank as a designated authority is not authorised to review or assess the techniques or practices applied by individual institutions, nor can Eesti Pank take measures under this article. **Article 103** of Directive 2013/36/EU lets the competent authorities apply the supervisory review and evaluation process in a similar or identical manner where the competent authority determines that institutions with similar risk profiles are or might be exposed to similar risks or might pose similar risks to the financial system. Following the supervisory review and evaluation process, the competent authority may then exercise the supervisory powers provided in articles 104, 105 (Specific liquidity requirements) and 106 (Specific publication requirements). The measure that Eesti Pank intends to introduce is not based on the supervisory review and evaluation process referred to in Article 97 nor are the measures provided in articles 104, 105 and 106 available to Eesti Pank, as Eesti Pank is the designated authority in the meaning of Directive 2013/36/EU. The aim of the intended measure is

	to safeguard the resilience of the banking sector against the impacts of potential negative scenarios, which may not easily be captured by models based on historical data. At the same time the application of a risk weight floor for mortgage exposures under article 458 of the Regulation does not interfere with or prevent the competent authorities from exercising their powers under articles 103,104,105 or 106. Under **Article 133** of Directive 2013/36/EU, each Member State may introduce a systemic risk buffer of Common Equity Tier 1 capital for the financial sector, or for one or more subsets of that sector, in order to prevent and mitigate long term non-cyclical systemic or macroprudential risks not covered by Regulation (EU) No 575/2013, in the meaning of a risk of disruption to the financial system with the potential to cause serious negative consequences for the financial system and the real economy in a specific Member State. While the buffer may be applied separately to subsets of the banking sector and may be based on the location of the exposures, it is not allowed to apply the measure to specific subsectors of exposures. The aim of the measure intended by Eesti Pank is to safeguard the sufficiency of the capitalisation of the banks using internal risk models against risks stemming from domestic mortgage loans. Application of the systemic risk buffer under article 133 does not allow any differentiation between the sectors impacted. A measure based on all exposures would have an impact on all exposures, including, for example, credit to the corporate sector and SMEs, which is not the desired impact of the intended measure. It is also stated in article 133 that a systemic risk buffer should only be applied where such risks are not covered by Regulation (EU) No 575/2013. Under **Article 136** of Directive 2013/36/EU the purpose of the countercyclical buffer is to mitigate the risks arising from excessive credit growth in the Member State and it should be based on the deviation of the credit-to-GDP ratio from its long-term trend. The countercyclical buffer rate is applied as a percentage of the total amount of risk exposure calculated in accordance with Article 92(3) of Regulation (EU) No 575/2013. Therefore it is not possible to apply the countercyclical buffer requirement to specific subsets of exposures.
5. Cross-border and cross-sector impact of the measure	
5.1 Assessment of cross-border effects and the likely impact on the internal market **(Article 458(2)(f) of the CRR and Recommendation ESRB/2015/2)**	The risk weight floor is to be applied on the basis of the exposure-weighted average risk weight of Estonian retail exposures secured by mortgages on immovable property. At more than 99%, the vast majority of retail loans secured by mortgages held by the IRB banks have been issued in Estonia. Therefore the likelihood of any direct impact on other Member States is small.
5.2 Assessment of leakages and regulatory arbitrage within the notifying Member State	Residential mortgage loans in Estonia are predominantly issued by credit institutions. The share of non-bank mortgage lending is small. The current capital buffers of credit institutions that would be subject to the intended measure are sufficient to allow them to meet the requirement without needing to raise additional capital. The current levels of the voluntary capital

	buffers mean that introducing this measure should not limit or significantly influence the lending by the credit institutions to other economic sectors.
5.3 Reciprocation by other Member States **(Article 458(8) of the CRR and Recommendation ESRB/2015/2)**	The proposed measure would apply to credit institutions licensed in Estonia. It would not apply to banks providing credit in Estonia through branches or as direct cross border lending. As at 1 March 2019, eight credit institutions and seven branches of foreign credit institutions are licensed to operate in the Estonian market. About 75% of housing loans are held by the two credit institutions with permission to use internal model approaches for credit risk assessment. The market share of branches was reduced by the merger of DNB Pank's operations with those of the branch of Nordea group in October 2017. At the end of 2018, 8% of all outstanding housing loans were held by branches of foreign credit institutions, the majority of them by a branch whose permission to operate in Estonia was withdrawn in February 2019. Other credit institutions operating in Estonia via branches that hold a market share of more than 1% use the standard approaches for calculating regulatory capital requirements. The provision of direct cross-border mortgage lending is currently very limited. According to the data published by the EBA only the financial groups operating in Estonia via subsidiaries or branches hold mortgage exposures in Estonia in volumes that exceed the reporting thresholds. **Because of the currently limited activity and market share of the foreign branches in the Estonian mortgage market, Eesti Pank has decided not to ask for reciprocity for the proposed measure.** Eesti Pank will follow developments closely and may reconsider the need for reciprocity should the share of residential mortgage loans issued by branches increase considerably.
6. Miscellaneous	
6.1 Contact person(s) at notifying authority	Jaak Tõrs, Head of Financial Stability Department +372 6680 905 jaak.tors@eestipank.ee
6.2 Any other relevant information	