

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

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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)	<ul style="list-style-type: none"> • The measure applies to retail exposures secured by mortgages on immovable property to obligors residing in Estonia. <p>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</p>

	<p>exposures (CR GB 2), Estonia, and the relevant cells are: row 070, and columns 105 and 125.</p> <ul style="list-style-type: none"> The measure applies to credit institutions that have adopted the IRB Approach. The measure applies on an individual and consolidated basis.
<p>2.3 Calibration of the measure</p>	<p>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, with a cumulative fall of 20% in real GDP, a fall of 50% in housing prices, and a rise in 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.</p> <p>Applying the model result to the size of the total 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, given the wide confidence interval and the current economic environment, the minimum level of the average risk weight for residential mortgage loans is set at 15% as the objective of the measure is to establish a floor to limit any further decrease in risk weights.</p>
<p>2.4 Suitability, effectiveness and proportionality of the measure (Article 458(2)(e) of the CRR)</p>	<p>High and growing exposure to residential real estate by Estonian households and banks is a source of key vulnerabilities for financial stability in Estonia. 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. Under favourable macroeconomic conditions the discrepancy between the persistently strong housing growth and the continuing decrease in model-implied risk weights may grow. The proposed measure would address the macroprudential concerns by pre-emptively limiting any further decrease in risk weights. The intention in setting an average risk weight floor is to ensure that they hold sufficient own funds to cover systemic risks related to mortgage loans and the residential real estate market.</p> <p>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 all 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, none 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 the proposed 15% risk weight floor would increase the total risk exposure amount for one bank.</p> <p>To address the macroprudential concerns in Estonia a floor-type measure was found more appropriate than an alternative set-up based on risk weight add-ons, as the aim of the measure is to avoid any further decrease of the risk weights. The 15% floor would apply for the exposure-weighted average of the risk weights applied to the portfolio of mortgage exposures. This means that the IRB banks would still have sufficient flexibility to apply lower risk weights to suit the risk profiles of individual loans.</p>

	<p>The direct negative spillovers from the proposed measure are limited as it would only apply to retail exposures secured by residential real estate property. Hence the measure would not significantly affect the other activities of banks, such as corporate financing.</p> <p>The impact of the measure on loan margins, loan growth and economic growth is expected to be negligible.</p>
2.5 Other relevant information	<p>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.</p> <p>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%.</p>
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.
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)

In recent years the **housing loan growth** in Estonia has been robust and persistent at above 6.5% from the middle of 2017 and 7.2% in April 2019, and has been substantially higher than the average growth in the euro area. Given the consistently rapid growth in wages, which was 7.9% in Q1 2019, strong consumer confidence and low interest rates, there is a risk of credit growth acceleration, which may lead to unsustainable levels of household debt.

The **indebtedness of Estonian households** is below the average of the member states of the European Union. Despite the rapid growth in debt liabilities there has been no rise in household indebtedness in recent years. 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 at 39% at the end of 2018. However, the volatility in Estonian GDP growth has historically been much higher than that in the euro area as a whole, and this increases the risks to household debt sustainability in Estonia.

Housing price growth in Estonia in 2013-2014 was strong at more than 12% on average and largely exceeded the growth in household income, but in the last two years prices have grown more slowly at 5-6%, which is more in line with income growth. The Eesti Pank econometric model for measuring overvaluation in the housing market finds that housing prices on average were probably not overvalued in 2018. However, the strong cyclical position of the economy means there is a risk that demand for housing could increase and cause acceleration in housing prices. Even though the developments in housing prices have largely been in line with income growth until now, wage growth may prove unsustainable or interest rates may rise, which would put both the ability of households to service their loans and current valuations in the housing market at risk.

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. Moreover, the share of housing loans in the total assets of the banks is almost twice the EU average¹. 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 banking sector in Estonia is **highly concentrated**. 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 share of the two IRB banks had grown to 75% of the total housing loan market, 4 pp higher than it was five years ago. Their share in new housing loans was even higher at 80% in 2018.

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.

	<p>This reflects the crucial role played by the IRB banks in the supply of housing loans to households. 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 to lend would to a large extent depend on the resilience of individual large banks.</p> <p>Under all these circumstances, the identified trend of declining risk weights of the IRB banks indicates a growing systemic risk that the resilience of the banking system to systemic risks related to residential real estate is being eroded. Over the past 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%. Given the growing discrepancy between the elevated level of systemic risks related to residential real estate and the continuing decrease in risk weights, Eesti Pank as the macroprudential authority is concerned that banks with substantial market share and exposure to the residential real estate market as a whole must be able to maintain its resilience to the systemic risk related to real estate. Estonia's past experience from 2008-2009 has shown that a deterioration in the economic environment can lead to significant debt servicing problems for households and that the need for credit institutions to make additional provisions for NPLs can increase very rapidly. Given the high level of exposure of Estonian banks to mortgages, the materialisation of any negative scenarios in the economy would have a significant impact on the Estonian economy and the financial sector.</p>
<p>4.2 Analysis of the serious negative consequences or threat to financial stability (Article 458(2)(b) of the CRR)</p>	<p>Residential mortgage loans make up a large share of the total exposure of the Estonian banking sector. This means that the declining risk weights could lead to insufficient capital being held against the systemic risks related to lending for residential real estate. If systemic risks were to materialise, the capital buffers of the banks 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.</p>
<p>4.3 Indicators prompting use of the measure</p>	<p>The main indicators are:</p> <ul style="list-style-type: none"> • 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 recently declined reflecting favourable macroeconomic conditions over the past years. However, looking forward, the level of risks stemming from the macroeconomic environment and from mortgage lending 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, the capital buffers they hold to safeguard against the systemic risks arising from residential mortgage loans have declined. At the same time the large market share of the IRB banks makes it especially important that they be sufficiently capitalised to withstand the impact of any potential downturn.

When 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 the suitability of the proposed measure for addressing 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. Article 124 does not apply to banks using the IRB 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. The underlying cause for Eesti Pank increasing the risk weights is not related to the dynamics of LGD values. An improved macroeconomic environment in Estonia has led to more favourable credit risk characteristics, and has helped to lower default rates and consequently led to lower PD values. Increasing the minimum LGD level by applying Article 164 would have only a limited effect on risk weights.

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 an institution's internal models, the competent authorities will 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. However, the internal model investigations conducted by the SSM are aimed at ensuring compliance with the Capital Requirements Regulation, rather than at addressing macro-prudential concerns.

An improved macroeconomic environment can be an important driver of the PD improvement in the context of internal models, mainly through more favourable credit risk characteristics within the portfolio and the calibration of the long-run average default rates for a 12-month horizon. At the same time, as the concern raised by Eesti Pank is of a macroprudential nature and is related to macroeconomic and systemic risks that relate to forward-

looking elements not captured by IRB models, the use of Article 101 CRD IV does not appear appropriate.

Article 103 of Directive 2013/36/EU allows the competent authorities to 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. More importantly, the systemic risk identified by Eesti Pank is mainly driven by the macroeconomic considerations (e.g. high levels of housing loan growth, the impact of a possible macroeconomic shock) and therefore a macroprudential measure would be more appropriate. The aim of the intended measure is to safeguard the resilience of the banking sector against the impacts of potential negative scenarios, which cannot be easily captured by models that use 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 or 105.

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 a Member State and it is guided by the deviation of the credit-to-GDP ratio from its long-term trend.

While housing loan growth has been strong, corporate debt has grown slowly in Estonia. Therefore the growth in total credit to the non-financial

	<p>sector has been moderate (2.9% in 2018) and has remained below both the nominal GDP growth for the current year and the long-term average nominal GDP growth.</p> <p>As 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, it is not a suitable instrument for addressing risks related to only a subset of exposures such as mortgage loans.</p>
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)	<p>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 the 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.</p>
5.2 Assessment of leakages and regulatory arbitrage within the notifying Member State	<p>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 credit institutions to other economic sectors.</p>
5.3 Reciprocation by other Member States (Article 458(8) of the CRR and Recommendation ESRB/2015/2)	<p>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.</p> <p>As at 1 March 2019, eight credit institutions and seven branches of foreign credit institutions were licensed to operate in the Estonian market. About 75% of housing loans were 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 which must cease its activities in Estonia by October 2019, according to the precept by the Estonian FSA. 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.</p> <p>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.</p> <p>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</p>

	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	