

## **Assessment of the notification by Finland in accordance with Article 458 of Regulation (EU) No 575/2013 concerning the application of a stricter national measure for residential mortgage lending**

### **Introduction**

On 27 June 2017 the European Systemic Risk Board (ESRB), in accordance with Article 458 of the Capital Requirements Regulation (CRR)<sup>1</sup>, received an official notification by Finanssivalvonta (FIN-FSA) of a decision taken by its Board on 26 June to adopt a national measure aiming to address increased systemic risk originating from the domestic market for residential mortgage loans. Under Article 458 of the CRR, the ESRB is required to provide the Council, the European Commission and Finland with an opinion within one month of receiving the notification. The opinion must be accompanied by an assessment of the national measure in terms of the points mentioned under Article 458(2) of the CRR.

**The ESRB's assessment focuses on the net benefits of the national measure for maintaining financial stability**, applying the procedural framework for providing opinions under Article 458 of the CRR as clarified in Decision ESRB/2015/4<sup>2</sup>. In particular, the ESRB has assessed the rationale and merit of the measure against the following criteria.

- **Justification:** has there been an increase in risk and does it pose a threat to financial stability at the national level? Can alternative instruments provided for under the Capital Requirements Directive (CRD IV)<sup>3</sup>/CRR adequately address the risk, taking into account their relative effectiveness?
- **Effectiveness:** is the measure likely to achieve its intended objective?
- **Efficiency:** will the measure achieve its objective in a cost-efficient way, i.e. has the appropriate instrument and calibration been used?
- **Proportionality and impact on the Single Market:** is there an appropriate balance between the costs resulting from the measure and the problem it aims to address, also 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 proposed measure assigns a credit institution-specific floor of 15% to the average risk weight for residential mortgage loans of credit institutions using the internal ratings based (IRB) approach.** Residential mortgage loans are defined in accordance with the Finnish

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<sup>1</sup> 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.

<sup>2</sup> Decision of the European Systemic Risk Board 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.

<sup>3</sup> 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 and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

Consumer Protection Act, and the 15% floor for the average risk weight is applied to mortgage loans on residential property located in Finland. The average risk weight reflects the weighted average of the risk weights of individual loans, which are defined as their exposure at default (EAD). In other words, the risk weights for individual loans may be lower than the 15% floor. In FIN-FSA's view this allows banks the necessary flexibility in lending while at the same time improving their resilience. The measure would be applied on a consolidated basis from 1 January 2018 onwards with reporting on a quarterly basis. Article 458.2(d)(vi) of the CRR allows the possibility of using higher risk weights for targeting asset bubbles in the residential and commercial property sector.

**The proposed measure will be introduced as a decision by FIN-FSA.** A FIN-FSA Board decision is sufficient to implement the measure without the need for further approval. Relevant stakeholders (the banks affected, the Finnish Ministry of Finance) were consulted during the drafting process for the decision. The decision of the FIN-FSA Board of 26 June 2017 to initiate the procedure under Article 458 of the CRR was preceded by two preliminary decisions (on 27 March 2017 and 14 June 2016<sup>4</sup>), which were also published by FIN-FSA.

**The ESRB further received a request from FIN-FSA to recommend reciprocation of the measure by other Member States under Recommendation ESRB/2015/2<sup>5</sup>.** This request will only be considered by the ESRB following completion of the notification and approval procedure and if and when the measure has been effectively adopted by the Finnish authorities. A possible ESRB Recommendation for reciprocation is therefore not considered further in this opinion, although the ESRB is open to it in principle.

In its assessment of the measure, the ESRB has drawn extensively on information provided by FIN-FSA and discussions with FIN-FSA and Bank of Finland staff, input provided by the European Central Bank (ECB), and the assessment performed by the ESRB in the context of its warning of 22 September 2016 of medium-term vulnerabilities in Finland's residential real estate (RRE) sector<sup>6</sup>.

## Section 1: Analysis of the underlying systemic risks

In its warning of 22 September 2016<sup>7</sup>, the ESRB considered the main medium-term vulnerabilities in the RRE sector in Finland to be the high and increasing level of household indebtedness, with more than a quarter of household debt being concentrated in a relatively small group of highly indebted households. The ESRB further mentioned that if risks were to materialise, there could be potential spillover effects to other countries in the Nordic-Baltic region.

### 1.1 Vulnerabilities in the residential property sector

**There are no indications of a significant and general overvaluation of residential property prices in Finland.** Overall RRE price developments have been relatively stable since 2011 and there are no clear indications of a significant and general overvaluation of prices at present.

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<sup>4</sup> The decision of 14 June 2016, however, referred to an average risk weight floor of 10% rather than 15%. FIN-FSA justifies an increase in the floor over a relatively short period as the result of further analysis and the recent improvement in the outlook for the Finnish economy (thus reducing the risk of a negative impact of the measure on the real economy).

<sup>5</sup> Recommendation of the European Systemic Risk Board of 15 December 2015 on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures.

<sup>6</sup> See also the ESRB report entitled "Vulnerabilities in the EU residential real estate sector", November 2016.

<sup>7</sup> Warning of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of Finland.

Nevertheless, regional differences have increased and prices are generally higher in growth centres (such as the greater Helsinki area) than in the rest of the country. Widely used indicators of potential overvaluation, such as the price-to-income (PTI) ratio and the price-to-rent (PTR) ratio, are close to their long-term averages, even if some indicators calculated by the ECB show that there might be a slight overvaluation. Given the weak outlook for the Finnish economy, there is, however, a risk of RRE price decreases due to, for example, an economic shock or an increase in long-term interest rates, notwithstanding the absence of an obvious overvaluation of RRE prices.

**New housing loans have relatively high loan-to-value (LTV) values.** According to a FIN-FSA sample-based survey covering the largest banks and conducted in Q2 2016, more than one third of new housing loans were granted with a self-financing share of below 10%, and in many cases the loan amount exceeded the purchase price. High LTV ratios have been more widespread among first-time home buyers. This means that a significant portion of new borrowers is sensitive to a fall in RRE prices. Based on FIN-FSA data collected for a 2014 survey, the average LTV was only 70% for newly issued mortgage loans and 58% for the total outstanding stock of mortgage loans.

**As of July 2016, a binding LTV limit of 90% (95% for first-time home buyers) was introduced for new mortgage loans.** This LTV limit is actually a “loan-to-collateral” (LTC) limit, meaning that collateral other than the mortgaged house can be taken into account as well. On average, collateral other than the purchased property accounts for 30% of the collateral put up for new mortgage loans<sup>8</sup>. According to the legislation, FIN-FSA may on certain grounds tighten the limit by another 10 percentage points. In addition, it may decide to restrict the use of collateral other than real estate collateral in calculating the LTV ratio.

## 1.2 Vulnerabilities in the household sector

**The main vulnerability is the high and increasing level of household indebtedness, especially among some groups of households.** The debt-to-disposable income (DTI) ratio of 115% as at Q4 2016 is relatively high compared with an EU average of 106% for the 19 countries for which data are available. This ratio has been growing continually since the late 1990s, irrespective of cyclical conditions. The mortgage debt relative to disposable income of mortgage-indebted households increased to 181% in 2015 compared with 121% in 2002. The household debt-to-GDP ratio of 68% as at Q4 2016 is also high compared with an EU average of 56%.

**According to FIN-FSA, two structural changes in the 2000s have contributed to the accumulation of housing debt:** (i) the increase in the average maturity of new housing loans (19.4 years in April 2017 compared with 11 years in 1997-98) and (ii) the increase in the average loan size (mortgage debt per household with a mortgage more than doubled, to EUR 96,000 in the period 2002-15).

**Debt is very unevenly distributed among households, being concentrated in a relatively small group of the most indebted households.** According to the latest data, 27% of housing debt is held by households whose total debt is over four times higher than their annual income (compared with 11% in 2002). Moreover, 10% of households have a DTI ratio above 300%, and they account for half of total housing debt and almost half of total household debt.

**Credit dynamics and debt servicing costs are presently somewhat less of a concern.** Loans for house purchases grew by 2.1% annually in May 2017 compared with 2.5% a year earlier. Debt servicing costs of households (7.1% of income as at Q4 2016) are low compared with European peers and have remained more or less flat over the past three years. This trend has been supported by the low level of interest rates. However, borrowers are quite sensitive to a

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<sup>8</sup> Collateral other than real estate properties represents around 2% of all collateral provided.

potential increase in interest rates since more than 95% of new and existing mortgage loans have a variable rate. In that respect, there is a risk that the increase in debt servicing costs associated with any future interest rate increase could dampen private consumption and negatively impact a weak cyclical recovery.

**A significant share of households' total assets consists of dwellings.** This is a reflection of the fact that owner occupancy is more common in Finland than renting. Moreover, house prices have risen significantly in some regions of the country (the greater Helsinki area). Any fall in house prices and/or increase in interest rates may therefore also have second-round effects on the economy via household consumption.

**A number of measures have already been taken to address the vulnerabilities related to the household sector.** Apart from the earlier-mentioned LTV cap, FIN-FSA also issued recommendations for banks in 2010 regarding the stress rate and amortisation rate to be used in credit assessments. Borrowers should be able to pay their mortgage debt assuming an interest rate of 6% and a maximum maturity limit of 25 years. In addition, the tax deductibility of housing loan interest payments is being gradually reduced from 100% to 25% over the period 2011-2019.

### 1.3 Vulnerabilities in the banking sector

**The Finnish banking sector is characterised by high and concentrated exposures to the RRE sector and a high degree of interconnectedness.** At end 2016, housing loans represented 47% of total loans to households and non-financial corporations (almost 10 percentage points higher than at the beginning of 2001) or 25% of banks' balance sheets, with the three largest banks accounting for 80% of the total housing loan stock. Moreover, the Finnish banking sector relies on wholesale funding for more than 50% of its total funding, in particular in the form of bonds secured by housing loans. These covered bonds currently account for 31% of banks' market funding and 41% of total bond funding (Q1 2017). The widespread use of covered bonds results in a higher level of bank asset encumbrance. The Finnish banking sector is strongly interconnected with the Nordic banking system through ownership links and cross-ownership of debt securities; this increases the risk that housing market problems in other Nordic countries could spread to Finland (and vice versa).

**Overall, the solvency position of the Finnish banking sector is high.** At end March 2017, the total capital adequacy ratio stood at 22.5% and the CET1 ratio at 20%, having declined by 1.0% and 1.6%, respectively, against March 2016, mainly reflecting the transformation of Nordea Bank Finland into a branch in early 2017. Banks' non-performing loans (NPLs) to households are also on the increase. NPLs to households represented 2.1% of the stock of household loans of banks in Q1 2017, compared with 1.5% in Q4 2014.

**Risk weights for mortgage loans are low compared with other Member States and the level of risk.** The average IRB risk weight for a mortgage loan is 7% compared with 25% for Sweden and Norway (for both countries after additional requirements), 13% for Denmark and a risk weight floor of 35% under the standardised approach.<sup>9</sup> This low level is explained by the fact that IRB risk weights are calibrated according to the advanced IRB requirements, with the available granular data as adjusted for severe-crisis loss levels. Since the way systemic risks are building up in the housing market has changed since the 1990s, the model correction may not fully take into account systemic risks apparent today.<sup>10</sup> Moreover, risk weights at individual

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<sup>9</sup> Banks applying the standardised approach represent about 10% of the total mortgage market in Finland.

<sup>10</sup> Because Finland has not experienced a severe banking crisis in the last 20 years, the granular default data currently available to the Finnish banks do not cover severe-loss scenarios like the 1990s banking crisis. Therefore, Finnish banks have adjusted their models to account for the severe-loss levels of this

bank level do not take into account any systemic risk considerations resulting from the accumulation of household debt mentioned earlier (including possible second-round effects through household consumption).

## Section 2: Effectiveness and efficiency of the measure

### 2.1 How the measure addresses the identified risk

**The measure should be considered as part of a wider set of initiatives that have been introduced over several years to address concerns about developments in the Finnish RRE sector (see above).**

**The purpose of the planned measure is to target potential asset bubbles in the RRE sector by strengthening the resilience of the banking sector.** Article 458.2(d)(vi) of the CRR allows the use of higher risk weights for targeting asset bubbles in the residential and commercial property sector. While there are no indications of a general asset bubble in the Finnish residential property market, the measure is motivated by the need to target a potential bubble at an early stage.

**According to FIN-FSA, the measure is also designed to address the problem that risk weights for residential property applied by IRB banks are insufficient to absorb the effects of a systemic RRE crisis.** In FIN-FSA's view, systemic risks are not and should not be explicitly taken into account in internal models. This objective influences the choice of the macroprudential instrument, as FIN-FSA requires that the instrument chosen must be able to directly increase banks' risk weights rather than overall capital levels.

**The measure would be taken in a preventive, forward-looking manner.** In the material supporting its warning to Finland, the ESRB did not find any clear evidence of a general overvaluation in RRE prices. Only some indicators calculated by the ECB show that there might be a slight overvaluation. In FIN-FSA's view, high and increasing household indebtedness, regional house price developments (with the greater Helsinki area outpacing the rest of the country) and the risk that the measure would have a limited mitigating effect if taken too late justify intervention now.

**The measure does not primarily seek to address the risk resulting from the high and increasing level of household indebtedness.** This risk was identified by the ESRB in its warning as the main medium-term vulnerability resulting from the RRE sector in Finland. This risk is only addressed indirectly by increasing the resilience of banks against the first and second-round effects of a downturn in the RRE sector. The ESRB will continue to monitor developments in household indebtedness in line with its warning.

**The measure may further increase the resilience of the banks affected by the measure, albeit to a small extent.** The measure would affect six banks active in the Finnish housing market, including two branches of banks from other Member States. Assuming that the measure is fully reciprocated, the banks affected would need to increase their CET1 capital by a total of EUR 500 million according to FIN-FSA. Overall, FIN-FSA and the Bank of Finland estimate the measure to be roughly equivalent to increasing the risk-weighted capital requirement by 1 percentage point. In terms of individual CET1 and capital adequacy ratios, the impact is estimated to be between 0 and 2 percentage points, depending on the bank in question and

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crisis. However, household indebtedness leading up to that crisis was approximately one-third lower (debt-to-disposable income ratio of around 80%) than it is today (debt-to-disposable income ratio of around 120%), and thus, despite having been corrected, banks' models may not fully take into account systemic risks apparent today.

the level of starting risk weights. The weighted average impact on banks' CET1 ratio is estimated to be 1.4 percentage points.

**The measure has been calibrated on the basis of various stress scenarios.** These scenarios include mainly national crisis experiences. According to FIN-FSA, an average risk weight floor of 15% would be sufficient to cover the first and second-round loan losses from such scenarios. This result is derived from three types of calibrations: the historical experience of the 1990s crisis, stress test results and a simulated macro model. All the calibrations yield risk weights of the same order of magnitude (between 10% and 15%). The most elaborate calibration, which arguably best justifies the 15% limit, is based on the "Gulan-Haavio-Kilponen" SVAR macro model. The model applies the shocks that took place in Finland during the 1990s banking crisis to the Finnish economy and banking sector in their current state. The implied risk weights are calibrated so that they cover the loan losses for a cumulative three-year period. Indeed, an important aspect of the calibration is that the loan losses accumulate over multiple years, reflecting the systemic nature of the crisis. This same assumption was also made with the historical and stress test calibrations.

**However, the Finnish banking sector is already very well capitalised.** The impact of the measure depends on whether the affected banks will cover the increased requirements by raising new capital or by reducing their voluntary capital buffers. At the end of March 2017, the total capital adequacy ratio stood at 22.5% and the CET1 ratio at 20%. None of the banks affected by the measure would need to raise new capital to meet the requirement. The impact of the measure on bank resilience will therefore depend on whether banks want to maintain their present voluntary capital buffers, which FIN-FSA expects to be the case.

**According to FIN-FSA, the overall impact of the measure on the EU single market would be positive.** The cross-border effects of the measure have been assessed in accordance with the ESRB Recommendation (ESRB/2015/2) on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures. The analysis shows that the probability of inward spillovers from the measure is limited, given that the calibration of the 15% risk weight floor is moderate. As the measure applies only to housing loans in Finland, outward spillovers should also be limited.

**Overall, the ESRB found that the measure would not entail disproportionate adverse effects for the Internal Market or other national financial systems.** The measure should further increase the resilience of Finnish banks to shocks in the Finnish housing market and thus reduce potential channels for contagion from Finland to other Member States. As the measure would involve increasing mortgage risk weights for Finnish housing loans towards the levels applied in other Member States while keeping the risk weights relatively low compared with other Nordic countries, this should not have a disproportionate adverse effect on the Single Market. Indeed, bringing mortgage risk weights more in line with other Nordic countries could be seen as levelling the playing field to some degree.

## 2.2 How the measure relates to possible alternatives

As required under Article 458 of the CRR, this section assesses whether other macroprudential instruments available under the CRD IV/CRR could adequately address the increase in systemic risk, taking into account their relative effectiveness. These instruments need to be considered before invoking Article 458 of the CRR to adopt stricter national measures.

### **a) Increasing the risk weights for banks applying the standardised approach (Article 124 of the CRR)**

**For banks using the standardised approach (SA), the competent authority may, under Pillar 1 of the CRD IV/CRR, increase the risk weights** for exposures secured by mortgages on immovable property from 35% to up to 150%, or apply stricter criteria for implementing the 35% risk weight on the basis of financial stability considerations.

**As only 10% of the relevant Finnish mortgage market exposures are held by banks applying the standardised approach, increasing the risk weights under Article 124 of the CRR would not be effective in meeting the objectives of the proposed measure.** In addition, the SA risk weight floor of 35% is seen as sufficient (compared with an average risk weight of around 7% for IRB banks). The proposed measure instead aims to specifically address the market segments exposed to the RRE risks, which are primarily based on IRB models. IRB risk weights are currently low in Finland as they are calibrated based on data which reflect limited historical losses in the Finnish market, failing to sufficiently take into account the systemic risks related to the current high level of household indebtedness. Altering SA risk weights would therefore not be relevant in this market context.

### **b) Increasing the loss-given-default floor for IRB banks (Article 164 of the CRR)**

**For IRB banks, the competent authority may, under Pillar 1 of the CRD IV/CRR, increase the exposure-weighted average loss-given-default (LGD) floor for retail exposures secured by residential property on the basis of financial stability considerations.** The LGD is one of the parameters used in the risk weight function (as well as the probability of default (PD)). Increasing the LGD level indirectly increases the risk weight and capital requirements.

**FIN-FSA argues that the need to increase the mortgage risk weights is not related to LGD values being too low. Raising the LGD floor would also affect banks' risk weights in a disproportionate manner. More generally, in FIN-FSA's view, systemic risks are not, and should not, be explicitly taken into account in internal models.** The average LGD level of most Finnish banks is close to the current LGD floor of 10%, which FIN-FSA considers to be appropriate. In FIN-FSA's view, increasing the average LGD floor would inappropriately widen the differences in risk weight levels between credit institutions. In particular, as a result of the approximately linear relationship that exists between LGD levels and risk weights in the regulatory risk weight function, the percentage-point increase in risk weights would in fact be highest for banks with average or high levels of risk weights. Because of this disproportionate effect on risk weights, FIN-FSA believes that directly raising the average risk weight floor is a more efficient and balanced way to address the concern that risk weights are too low in view of the prevailing systemic risks.

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

**Member States may introduce a systemic risk buffer to address long-term non-cyclical systemic or macroprudential risks not covered by the CRR.** The systemic risk buffer can be applied to all banks or to a subset of banks.

**The systemic risk buffer is presently not available under Finnish law.** Under the CRD IV, Member States may introduce a systemic risk buffer of CET1 capital to prevent and mitigate long-term non-cyclical systemic or macroprudential risks not covered by the CRR. Finland has so far not made use of this possibility, but a Government proposal for a systemic risk buffer is expected to be submitted to Parliament fairly soon (with the timetable and the outcome of this process being uncertain).

**Since the measure under Article 458 of the CRR is of a temporary nature, the Finnish authorities will consider whether to retain the systemic risk buffer when the average risk**

**weight floor is reviewed in 2019.** However, the authorities have expressed doubts as to whether the systemic risk buffer would be able to address the specific concern of low risk weights for housing loans.

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

**The CRD IV provides for the introduction of a countercyclical capital buffer to address some of the procyclicality in the financial system.** The countercyclical capital buffer is a requirement for domestic exposures. The rate for the countercyclical capital buffer is set on a quarterly basis by the designated authority, typically subject to a twelve-month lead time before the rate needs to be applied by banks.

**The countercyclical capital buffer rate would apply to all Finnish exposures, not residential mortgage lending alone.** The benefit of such a broad instrument would be that all exposures, including direct cross-border or branch lending, would be subject to mandatory reciprocity. The drawback, however, is that the buffer would not appropriately target the specific risk identified by FIN-FSA. In addition, FIN-FSA notes that there is no sign for the time being of general excessive credit growth, as for example reflected in the credit-to-GDP gap and supplementary information. Currently, the countercyclical capital buffer rate is set at 0% in Finland.

#### **e) Using Pillar 2 (Articles 101, 103, 104 and 105 of the CRD IV)**

**Under the supervisory review process (Pillar 2 of the CRD IV/CRR), the competent authority can implement a wide range of supervisory measures** to address (elements of) risk that are not sufficiently covered by Pillar 1 and provide incentives for banks to enhance their risk management (see Article 104 of the CRD IV). Furthermore, the CRD IV allows the use of Pillar 2 for macroprudential purposes (see Article 103 of the CRD IV). There is actually at least one precedent for the use of Pillar 2 in addressing the type of risk of concern to FIN-FSA: in 2013 Sweden's financial supervisory authority *Finansinspektionen* introduced, under Pillar 2, a risk weight floor of 15% for Swedish mortgages, which was later increased to 25%. The 15% risk weight floor was calibrated based on idiosyncratic credit risk (i.e. bank-specific credit losses), and the increase to 25% was motivated by structural systemic risk factors.<sup>11</sup> This measure was publicly disclosed by the supervisor.

**FIN-FSA has put forward several arguments in favour of using a Pillar 1 measure instead of a Pillar 2 measure. The ESRB agrees with these arguments.**

- **Different supervisory approaches as regards Pillar 2.** FIN-FSA points out that the outstanding stock of mortgage loans is held by entities supervised by different national and European authorities (see Section 3.2), including FIN-FSA, the Swedish *Finansinspektionen*, the Danish *Finanstilsynet* and the European Central Bank (ECB) under the Single Supervisory Mechanism (SSM). Since these authorities all have their own approach as regards Pillar 2, the use of a measure under this regime may result in uncertainty and inconsistency. There is also no explicit legal foundation for Pillar 2 measures in the CRD IV comparable to the voluntary reciprocity under Article 458 of the CRR and supplemented by the reciprocity framework developed by the ESRB<sup>12</sup>. Furthermore, in FIN-FSA's view ECB Banking Supervision seeks to maintain Pillar 2 as a microprudential rather than a macroprudential instrument. Finally, whereas the disclosure practices of supervisory authorities vary as

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<sup>11</sup> See EBA [Report on the range of practices regarding macroprudential policy measures communicated to the EBA – July 2015](#).

<sup>12</sup> Recommendation of 15 December 2015 on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures (ESRB/2015/2).

regards Pillar 2 measures, FIN-FSA regards the financial stability benefits that may result from the publication of the proposed measure as uncertain.

- **Lack of justification for using Article 101 of the CRD IV.** Banks using internal models comply with the requirements of the CRR in FIN-FSA's view; no breach of the Regulation has been found. FIN-FSA further notes that a targeted review of banks' internal models (TRIM) by the ECB is currently under way for one Finnish banking group. The low risk weights that can be observed arise from the backward-looking statistical nature of the models.<sup>13</sup> Furthermore, the current risk weight calculation based on the formula of the Basel Committee on Banking Supervision does not, in the view of FIN-FSA, adequately capture systemic risk. FIN-FSA considers the risk weights to correctly reflect microprudential risks and argues that recalibrating the models is not the correct approach for addressing a risk that is macroprudential in nature. It should be noted in this regard that the Swedish authorities took a different view, having imposed a 15% risk weight floor under Pillar 2 based on an overall assessment of future loss levels in Swedish mortgages in an intense financial stress situation (the floor was later increased to 25% on the basis of macroprudential considerations).

#### **f) Directly addressing household indebtedness**

**Given the concerns expressed by the ESRB in its warning about the high and increasing level of household indebtedness as the main medium-term vulnerability for the RRE sector, Finland might also consider strengthening or introducing measures to more directly address this vulnerability.** The ESRB understands that income-based instruments such as caps on loan-to-income (LTI), debt-to-income (DTI) and debt service-to-income (DSTI) are currently lacking in the macroprudential toolkit of the Finnish authorities, but that discussions regarding the corresponding expansion of the toolkit are under way. Income-based instruments may be a more direct, effective and efficient way to address the prevailing vulnerabilities, particularly in combination with the existing LTV limits.

Depending on which authority is mandated to use the instrument, its use may be somewhat politically sensitive given the ensuing short-term distributional consequences, as the instrument would restrict access to credit for certain segments of the population. Such measures would also target only the flow of new loans, thus leaving the risk embedded in the outstanding stock of loans unaddressed. In addition to income-based instruments, household indebtedness can also be addressed through tax measures, such as the gradual reduction of the deductibility of housing loan interest payments from 100% to 25% over the period 2011-19 as introduced by the Finnish authorities.

### **Section 3: Net benefits analysis of the measure**

#### **3.1 Effects on financial stability, financial system resilience and economic growth**

**The measure is expected to further increase the resilience of the affected banks, albeit to a small extent.** Assuming that the measure is fully reciprocated, the banks affected would need to increase their CET1 capital by a total of €500 million according to FIN-FSA. Overall, FIN-FSA and the Bank of Finland estimate the measure to be roughly equivalent to increasing the risk-weighted capital requirement by 1 percentage point. In terms of individual CET1 and capital adequacy ratios, the impact is estimated to be between 0 and 2 percentage points, depending on the bank in question. In terms of the stock of total mortgage loans, the measure would

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<sup>13</sup> See footnote 10.

impact banks representing around 75% of total housing loans<sup>14</sup>. Owing to the high level of interconnectedness in the Finnish banking sector, in particular with the Nordic banking sector, a more resilient Finnish banking sector would also be beneficial in terms of financial stability in the EU. It should further be noted that, under the procedure laid down in Article 4 of Decision ESRB/2015/4, no member of the General Board raised any material concerns regarding negative externalities of the measure, in terms of adverse cross-border spillover effects.

**The Finnish authorities expect the impact of the measure on banks' funding costs, loan margins and economic growth to be limited.** The measure is estimated to increase the funding costs of banks by a maximum of 10 basis points. Similarly, the increase in the average housing loan margin for the bank with the lowest average risk weights is expected to be 10 basis points at most in comparison with levels in late 2016.

### 3.2 Effects on domestic and cross-border lending

**Nordic banking groups are important players in the Finnish market.** Swedish (Nordea, Handelsbanken) and Danish (Danske Bank) banking groups have important market shares through branches and/or subsidiaries. Foreign branches account for 18% of the stock of loans to households and non-financial corporations. The two most significant branches are those of Nordea and Handelsbanken, both Swedish banking groups, and Nordea has a presence in Finland through both a branch and a subsidiary. Just like Finland, Sweden and Denmark received an ESRB warning in late 2016 about the existence of medium-term vulnerabilities in the RRE sector. Cross-ownership of debt securities (covered bonds) of Nordic banking groups is also prevalent. Through these foreign ownership links, housing market problems in Sweden and Denmark could potentially spread to Finland's financial system, and vice versa.

### 3.3 Effects on banking groups' intragroup behaviour

**Given that banks are able to meet the increased capital requirement with existing capital buffers, it is unlikely that this measure will cause a significant shift in capital from operations to other countries.**

**In the light of a possible reciprocation of the measure, the possible rebooking of mortgage loans from Finnish subsidiaries to Finnish branches or the transformation of subsidiaries into branches should be monitored by the ECB, FIN-FSA and the EBA.** When notifying the ESRB of the measure, FIN-FSA indicated that it would like to ask the ESRB to recommend that other Member States to reciprocate it. This request, to which the ESRB is in principle open, will only be considered by the ESRB if and when the measure has been effectively adopted by the Finnish authorities.

**The development of mortgage lending – both direct cross-border lending and lending through branches – should be monitored over time.** A further investigation of developments at institution level (in particular by the supervisory colleges of the banking groups concerned) could take place if there were a significant pick-up in such activity.

## Conclusions

**According to FIN-FSA's assessment, changes in the intensity of macroprudential/systemic risk in the Finnish financial system and the RRE sector as a source of risk require macroprudential action.** The Finnish authorities have acted accordingly with a set of measures in recent years, including an LTV cap, a progressive reduction of the tax deductibility of

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<sup>14</sup> The banks that are not impacted are IRB banks with an average risk weight of more than 15% as well as banks using the standardised approach.

mortgage loans and the planned introduction of a minimum average risk weight for mortgage loans. The existence of vulnerabilities in the RRE sector is corroborated by the ESRB's recent warning to Finland, which identified the high and increasing indebtedness of households, especially among some groups of households, as the main medium-term vulnerability. The ESRB warning noted that the medium-term vulnerabilities identified in the Finnish RRE sector are a source of systemic risk to financial stability and may have the potential for serious negative consequences for the real economy.

**The ESRB welcomes the fact that the Finnish authorities have been taking action to address the vulnerabilities in the RRE market identified in the ESRB warning.** The ESRB is of the view that the planned measure may contribute somewhat to further enhancing the resilience of the Finnish banking sector to a potential correction of RRE prices, which should be welcomed. While the indicators do not point to general overvaluation in the Finnish RRE market, some regions (such as the greater Helsinki area) have experienced much bigger price increases than the rest of the country in recent years. This phenomenon is not evident from the general development of RRE prices, but the changes observed at regional level could potentially spread further. Early macroprudential intervention should therefore be welcomed. Other Member States have, incidentally, seen similarly diverging RRE price trends, and some are trying to address these developments by tailoring the scope or calibration of borrower-based instruments. The overall increase in the resilience of the Finnish banking sector following the adoption of the planned measure would all in all be rather limited (in the order of 0 to 2 percentage points of the CET1 or total capital adequacy ratio of the affected banks).

**The alternative macroprudential instruments listed in Article 458 of the CRR, which must be considered before any stricter national measure can be taken, either do not seem to adequately address the risk in the Finnish RRE market or are currently not available to the Finnish authorities.** Measures such as those listed in Articles 124 and 164 of the CRR, as well as the systemic risk buffer and the countercyclical capital buffer, are considered to be inadequate, either because they provide the wrong incentives, are too broad-based, do not address the relevant type of risk or bank, or are not available under Finnish law. While Pillar 2 comes closest as a possible alternative in terms of adequacy and relative effectiveness, a national measure under Pillar 1 is preferable in the specific case of Finland because the intervention is motivated by macroprudential concerns as well as for transparency and disclosure reasons. Moreover, under the SSM set-up, FIN-FSA is no longer the competent authority for Pillar 2 measures for significant institutions. Finally, the ESRB did not find the measure to entail disproportionate adverse effects for the Internal Market or other national financial systems.

**The ESRB therefore considers the measure to be a useful further addition to the existing set of measures addressing vulnerabilities in the RRE sector in Finland. At the same time, the ESRB would like to flag a number of issues that require further follow-up.**

**First, whether the measure may effectively increase the resilience of the banking sector as envisaged by the Finnish authorities will ultimately depend on the reaction of the targeted banks.** Banks may cover the increased requirements by acquiring new capital or by reducing their voluntary capital buffers. Based on international experience and academic evidence, FIN-FSA expects banks to maintain their present voluntary capital buffers, but this cannot be taken for granted. Authorities should therefore closely monitor how banks adjust their capital position in response to the measure and, in particular, to what degree they substitute mortgage lending with other types of assets.

**Second, while in FIN-FSA's view there are no indications that credit institutions with low average risk weights are underestimating the microprudential risk in their exposures, this may need to be qualified somewhat.** One objective of the measure is to increase risk weights

on housing loans in Finland. Following a decision by the ECB as microprudential supervisor in early 2016, a major Finnish banking group was required to raise its risk weights for retail exposures after the ECB identified shortcomings in the IRB validation process applied by the banking group when measuring capital adequacy. The Finnish and European authorities should therefore be alert to the possibility that other institutions – significant or less significant within the meaning of the SSM Regulation<sup>15</sup> – may pose similar model deficiencies warranting corrective action. While coordination across a number of different national and European supervisory authorities is challenging, a consistent approach to ensuring appropriate housing loan risk weights in Finland is important.

**Third, consideration should be given to the use of the systemic risk buffer if and when it becomes available under Finnish law.** In FIN-FSA's view the macroprudential/systemic threat confronting the Finnish financial system is currently mainly of a structural nature. The systemic risk buffer is a flexible instrument for addressing long-term non-cyclical systemic or macroprudential risk not covered by the CRR. Moreover, it can be applied to all exposures or domestic exposures only, as well as to all credit institutions or a sub-set of institutions.

**Fourth, the measure only indirectly addresses the high and increasing level of household indebtedness,** which the ESRB identified as the main medium-term vulnerability in the Finnish RRE sector. The ESRB understands that while income-based macroprudential instruments, such as limits on LTI, DTI or DSTI, are not available under Finnish law for now, they may become available in the future. If the aforementioned vulnerabilities do not abate or increase further, the use of more direct, income-based measures may be warranted if and when they become available under Finnish law. Until that time, recommendations or opinions on prudent lending may be necessary. Improving the financial literacy of borrowers could also support households in managing indebtedness and encourage more prudent risk-taking.

**Fifth, the authorities should take action to further increase the effectiveness of the existing LTV cap.** The authorities argue that the measure proposed under Article 458 of the CRR should be considered as part of a wider set of measures. However, for this package to be effective it is important that all its components work well. FIN-FSA observes that current LTV caps have been circumvented to some extent by borrowers using consumer credit and tailored credit risk guarantee products that are considered as eligible collateral in calculating LTVs. It is therefore important that existing rules regarding the LTV are further tightened to restrict any such circumvention. Although at present the role of non-banks in the Finnish housing loan market is negligible, the growing use of tailored credit risk guarantee products will need to be followed up.

**Sixth, the effectiveness of the measure will also depend on the extent to which it will be reciprocated by other Nordic countries with banks active in the Finnish mortgage market.** Branches of Nordic banks finance a significant share of the Finnish mortgage market. These may therefore have a competitive advantage unless they become subject to the same or an equivalent measure for their Finnish mortgage activities. The development of mortgage lending through direct cross-border lending or branches should also be closely monitored over time, as should changes in the corporate structures of the relevant Nordic banking groups.

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<sup>15</sup> Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.