



Assessment of the Estonian notification 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 15 April 2019 Eesti Pank notified the European Systemic Risk Board (ESRB) of its intention to adopt a stricter national measure concerning risk weights under Article 458(2)(d)(vi) of the Capital Requirements Regulation (CRR)¹. Eesti Pank is the designated authority responsible for the application of Article 458 of the CRR in Estonia.² The draft measure provides for 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 internal ratings-based (IRB) approach for calculating regulatory capital requirements.

Pursuant to Article 458(4) of the CRR, the ESRB must provide the Council, the European Commission and Estonia 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 procedural framework for the provision of opinions under Article 458 of the CRR is clarified in Decision ESRB/2015/4³.

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

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

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

² In accordance with Article 24¹(6) of the **Eesti Pank Act**, Eesti Pank has the power to take measures related to Article 458 of the CRR.

³ 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.

⁴ 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 (OJ L 176, 27.6.2013, p. 338).

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

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

Section 1: Description of and background to the measure

1.1 Description of the measure

The draft measure provides for 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 exposures are referred to in this assessment as "Estonian mortgage loans". The measure is intended 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 (REE) market.

The measure applies to credit institutions licensed in Estonia that have authorisation to use the IRB approach for calculating regulatory capital requirements ("IRB credit institutions") and have exposure to Estonian mortgage loans. The measure applies to credit institutions on an individual and consolidated level, including subsidiaries of foreign credit institutions based in Estonia. It does not apply to credit institutions that use the standardised approach to calculate the capital requirement for credit risk or foreign banks providing credit in Estonia through branches or their direct cross-border exposures in Estonia. As at 1 March 2019 eight credit institutions and seven branches of foreign credit institutions are licensed to operate in the Estonian market. Approximately 75% of Estonian mortgage loans are held by two IRB credit institutions that fall under the scope of this measure.

The proposed measure is scheduled to enter into force in the third quarter of 2019, and will thus affect the capital requirements of banks as of the third quarter of 2019. The measure is intended to apply for two years. It will be introduced by a decree of the Governor of Eesti Pank published in Riigi Teataja, the official gazette of the Republic of Estonia. The measure, together with its justification, will also be published on the website of Eesti Pank.

Since the impact of the draft measure, according to the information provided by Eesti Pank, may be higher than 25% of the risk weights applied by IRB credit institutions, Article 458(10) of the CRR does not apply.

Eesti Pank does not intend, at this stage, to request reciprocation of the draft measure by other Member States given the current limited activity and market share of foreign branches in the Estonian mortgage market. At the end of 2018, 8% of all outstanding Estonian mortgage loans were held by branches of foreign credit institutions. The majority of these exposures were held by one branch, of which the licence 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 standardised approach to calculate regulatory capital requirements. In addition, the provision of direct cross-border mortgage lending is currently very limited. Eesti Pank will follow developments closely and may reconsider the need for reciprocity should the share of Estonian mortgage loans issued by branches increase considerably. Any such request for reciprocation would be considered by the ESRB.

1.2 Background to the measure

The draft measure will complement a suite of macroprudential instruments already used by Estonian authorities. Currently, the main macroprudential measures in use are the following:⁵

- Borrower-based measures applicable to new mortgage loans since March 2015: a loan-to-value (LTV) limit of 85%, a debt service-to-income (DSTI) limit of 50%, and a maximum maturity for housing loans of 30 years.
- A systemic risk buffer of 1%, which applies to all banks for their domestic exposures.⁶
- An other systemically important institutions (O-SII) buffer of 2% applicable to three banks and a buffer of 1% applicable to one bank, which have been identified as an O-SII. The O-SII buffer is additive to the systemic risk buffer. The two IRB credit institutions are both subject to an O-SII buffer requirement of 2%.
- The countercyclical buffer is currently set at 0%.

According to Eesti Pank, the draft measure aims to address vulnerabilities in the residential real estate market (see the following section for further analysis) and will also help to ensure that active macroprudential buffers remain effective. If the risk weights were to decline further, the buffers would become less effective, because they use risk-weighted assets as a basis. This could mean the established buffers could prove insufficient if systemic risk were to materialise.

⁵ See: <https://www.eestipank.ee/en/financial-stability/macroprudential-policy-tools>

⁶ The reasons for applying the systemic risk buffer requirement lie in the small size and openness of the Estonian economy, which make it vulnerable to negative developments in the external environment. The problems caused by unforeseen negative shocks may emerge rapidly and have a greater impact than in many other European countries. The risks to financial stability are increased by the lack of diversity in the credit portfolios of the banks and the relatively small financial assets held by households. The buffer requirement helps to ensure that the banks have sufficient capital to cover systemic risks.

Section 2: Analysis of the underlying systemic risks

The ESRB has been monitoring risks related to the residential real estate sector in all European Union (EU) Member States over the past few years. In 2016 it concluded that the policy measures taken by Estonian macroprudential authorities were appropriate and expected to be sufficient given the prevailing level of and trend in vulnerabilities. Against this background, Estonia was not an addressee of an ESRB warning in 2016. More recently, the ESRB renewed this assessment, determining that past developments have not fundamentally changed, despite some moderate price increases and credit growth. Therefore, although the ESRB is continuing its monitoring, it is currently not preparing to issue a warning or a recommendation to Estonia. Nevertheless, while risks in the residential real estate sector have neither markedly increased nor decreased, a further decline in the risk weights of the relevant IRB credit institutions per se would cause a reduction in the resilience of banks to vulnerabilities in the RRE sector.

The vulnerabilities related to RRE have not decreased in the recent past. Indicators for the real estate market, bank lending and the economy as a whole do not point towards a decrease in the level of cyclical risk, which has been significant in the past few years. As housing prices and mortgage lending have both been growing steadily, there is a concern that reinforcing dynamics between the two could create incentives for banks to take on more risk. Moreover, credit growth can further fuel the accumulation of household indebtedness, which is already high compared with other European countries.

However, according to Eesti Pank, the average risk weight of housing loans at Estonian IRB credit institutions has been falling. Over the past five years, the exposure-weighted average risk weight of mortgage-backed retail exposures of IRB credit institutions has fallen from 17.8% to 13.4%. The decline in risk weights may reflect the recent favourable economic conditions, which have reduced the volume of non-performing loans. Eesti Pank has nevertheless taken the view that the downward trend should be counteracted through the proposed measure.

In the following sections, further details on the assessment of vulnerabilities are provided, distinguishing between those affecting the RRE sector (Section 2.1), the household sector (Section 2.2), and the banking sector (Section 2.3).

2.1 Vulnerabilities in the residential real estate sector

According to the ESRB's assessment, housing prices have exhibited steady growth over the past three years, accompanying the expansionary phase of the economy. Over the past three years, real average annual growth was 3.6% (in the fourth quarter of 2018) and over the past year it stood at 3.4% (real annual growth in the third quarter of 2018). There are no substantial restrictions on housing supply and the price elasticity of supply is relatively high. This may mitigate pressures on RRE prices, but could also lead to an overshooting in the construction sector in the short run.

Eesti Pank's assessment suggests that these trends might however be exacerbated over the next few years. Rapid growth in wages and strong consumer confidence may further increase demand in the housing

market and cause real estate prices to rise faster. With interest rates at low levels, this could increase the growth in housing loans and leave the banks more vulnerable to real estate sector risks. Nevertheless, the ESRB considers that these risks are primarily related to new flows of credit and that borrower-based measures already in place could help to contain this risk.

2.2 Vulnerabilities in the household sector

According to the ESRB's assessment, the indebtedness of Estonian households is high compared with central and eastern European countries, albeit lower than the euro area average. Household debt accounted for 70% of disposable income and around 40% of GDP at the end of the third quarter of 2018. Housing loans, which constitute the largest part of household debt liabilities, recorded a yearly growth rate of 7% in 2018, more than twice the average growth of housing loans in the euro area. Vulnerabilities may be aggravated by the large share of mortgages with variable interest rates (which represented 90% of the flow of new loans in the fourth quarter of 2017). However, mortgage debt tends to be concentrated in households with higher income and larger financial assets, which would more easily be able to absorb the impact of potential adverse shocks. In the ESRB's view, the vulnerabilities in the household sector are material, but overall contained, in view of the macroprudential policy measures in place.

Eesti Pank highlights that risks related to indebtedness could be underestimated owing to the volatile nature of economic growth in Estonia. The levels of household debt must be put into perspective given that disposable income and GDP in Estonia have registered some of the highest growth rates in the EU. It should also be noted that the volatility of real GDP growth in Estonia has been much higher than that of the euro area as a whole. This increases the risks to debt sustainability, especially when the economy is running above its potential level and given that the probability of a sharp adjustment of growth rates is greater than in previous years.

2.3 Vulnerabilities in the banking sector

Housing loans represent a relatively large share of total loans in Estonia. At the end of 2018, housing loans accounted for 41% of the non financial sector lending portfolio, 29% of banking sector assets and 29% of GDP. Housing loans measured as a share of GDP are 8 percentage points lower than a decade ago, but the share of the banks' real estate sector lending portfolio has increased by 5 percentage points over the same period. The share of housing loans in the total loan portfolio of Estonian banks is approximately 1.5 times larger than the EU average, and housing loans are almost twice the EU average as a share of the total banks' assets.⁷ Having such

⁷ The large gap compared with the euro area average arises partly because the portfolio of loans to the private sector makes up a relatively large part of Estonian banking sector assets, while the share of debt securities is very small.

a large share of housing loans in the total loan portfolio and total banks' assets highlights the sensitivity of banks to negative developments in the RRE market.

The Estonian banking sector is highly concentrated. As at 1 March 2019 eight credit institutions and seven branches of foreign credit institutions are licensed to operate in the Estonian market.⁸ At the end of 2018, approximately 75% of housing loans were held by the two IRB credit institutions, which was 4 percentage points higher than five years ago. Their share in new housing loans was even higher, at 80%, in 2018. This reflects the crucial role played by IRB credit institutions in the supply of housing loans to households.

However, according to the ESRB's assessment, the growth in housing loans has been moderate, and collateralisation appears to be conservative. In the third quarter of 2018 the real annual growth of household loans for house purchases adjusted for sales and securitisations was 3.3% (3.2% over the past three years). In the second quarter of 2018, new lending (excluding renegotiations) over one year increased by roughly 18% compared with the stock of housing loans one year earlier. Furthermore, the average LTV has remained close to 70% for new housing loans as a whole, and the weighted average DSTI value has risen slightly from 27% to 28% over the past two years. Nonetheless, the distributions of the stressed DSTI ratio and the actual ratio from the repayment schedule have both shifted towards slightly higher values than in the recent past. Furthermore, the Estonian banking sector is interconnected with those of other Nordic countries, making it vulnerable to potential spillovers in the event of a downturn in the financial sectors of neighbouring countries.

Section 3: Effectiveness and efficiency of the measure

3.1 How the measure addresses the identified risk

The draft measure would complement a wider set of existing initiatives introduced over several years to address risks in the Estonian banking and RRE sector. Since 2014 all credit institutions in Estonia have been required to maintain a systemic risk buffer to address the long-term non-cyclical risks stemming from structural vulnerabilities of the Estonian economy.⁹ In March 2015 Eesti Pank applied three borrower-based requirements to credit institutions for issuance of mortgage loans.

⁸ The small market in Estonia means that there have only ever been a few housing loan suppliers, making competition fairly weak. In recent years structural changes in the banking market have weakened the degree of competition even further. See <https://www.eestipank.ee/en/publication/financing-economy/2019/financing-economy-february-2019>

⁹ The reasons for applying the systemic risk buffer requirement lie in the small size and openness of the Estonian economy, which make it vulnerable to negative developments in the external environment. The problems caused by unforeseen negative shocks may emerge rapidly and have a greater impact than in many other European countries. The risks to financial stability are increased by the lack of diversity in banks' credit portfolios and the relatively small financial assets held by households. The buffer requirement helps to ensure that the banks have sufficient capital to cover systemic risks.

According to Eesti Pank, the primary objective of the draft macroprudential measure is to prevent a further decline in the risk weights applied by IRB credit institutions to the portfolio of Estonian mortgage loans. This sets a macroprudential backstop, which – in Eesti Pank’s view – will maintain the resilience of IRB credit institutions against systemic risks related to mortgage loans and the RRE market. 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%. This decrease has only been observed in the portfolio of Estonian mortgage loans, not for other exposure classes.

Eesti Pank intends to use the measure in a primarily preventive, forward-looking manner. On the one hand, Eesti Pank argues that the fall in risk weights reflects the favourable economic conditions in recent years, which has reduced the volume of non-performing loans. On the other hand, according to Eesti Pank, systemic risks in Estonia’s RRE sector have not diminished and therefore, based on a forward-looking perspective, risk weights should be prevented from decreasing further. Otherwise, risk weights for exposures to residential mortgages may not sufficiently reflect the potential credit losses that could occur in the event of a sharp slowdown in growth. According to Eesti Pank’s baseline macroeconomic forecast, the conditions for household creditworthiness will remain favourable, for example relatively strong wage growth, low unemployment, and low base interest rates, meaning that risk weights are expected to continue to decline. These factors underline the preventative nature of the proposed measure.

Eesti Pank calibrated the draft measure based on an assessment of credit losses from Estonian mortgage loans under a stress scenario. This scenario assumes a macroeconomic shock similar to the one affecting Estonia in 2008-09 in reaction to the global financial crisis. The shock corresponds to a cumulative fall in real GDP of 20%, a decrease in housing prices of 50% and an increase in the unemployment rate 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.¹⁰ Applying the model result to the size of Estonian mortgage loans would result in an estimated minimum level for the average risk weight for residential mortgage loans of 16% to absorb the losses. However, the confidence interval for such an assessment is fairly wide, showing that the minimum risk weight necessary to absorb the losses may fall in a range from 10% to 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, i.e. marginally below the estimated minimum level.

According to information provided by Eesti Pank, applying the measure will increase the aggregate risk exposure of IRB credit institutions by €140 million or 2.2%. The Common Equity Tier 1 (CET1) ratio of the banks would fall on average by 0.8 percentage points. The capital ratios of both IRB credit institutions are

¹⁰ According to Eesti Pank, in response to the economic crisis, in 2009 the loan loss ratio of housing loans rose to 3.3%. The stress test showed that a shock of the same size would result in lower loan losses (1.4%), reflecting the current economic environment and households’ balance sheets.

substantially larger than required (weighted average CET1 ratio of 39.2% at the end of 2018), and neither of them is expected to need to raise any additional capital. Currently, the proposed floor will only affect one IRB credit institution, but it will also act as a backstop for the second IRB credit institution should risk weights decline further.

Eesti Pank also suggests that the introduction of a minimum level of 15% for exposure-weighted average risk weights would help to ensure that macroprudential buffers remain effective. Capital buffers such as the systemic risk buffer, the O-SII buffer and the countercyclical capital buffer use risk-weighted assets as a base. If the risk weights were to decline further, these buffers would become less effective and, according to Eesti Pank, potentially insufficient, if systemic risk were to materialise. The same considerations apply to all capital requirements, which are calculated in terms of risk-weighted assets, while the leverage ratio requirement serves as a non-risk-weighted backstop.

The ESRB is of the view that the measure acts as a backstop, hindering a further decline in risk weights in RRE portfolios. While it is expected to have a negligible effect on the actual capitalisation of the banks in the short term, from a forward-looking perspective, it would prevent further declines in risk weights, thereby ensuring the effectiveness of the capital ratios.

3.2 How the measure relates to possible alternatives

a) Increasing the risk weights for banks that use the standardised approach to credit risk (Article 124 of the CRR)

Competent authorities can impose higher risk weights for exposures secured by mortgages on credit institutions that apply the standardised approach, on the basis of financial stability considerations.

Competent authorities can set a risk weight for exposures secured by mortgages on residential immovable property, ranging from 35% to 150%. Additionally, they can apply stricter criteria for the application of a 35% risk weight.

Article 124 of the CRR would not be effective in meeting the measure's objectives, given that 75% of Estonian mortgage market exposures are held by credit institutions that apply the IRB approach.

Furthermore, the risk weight of 35% under the standardised approach is considered to be sufficient compared with the proposed risk weight floor of 15% for IRB credit institutions.

b) Increasing the loss given default (LGD) floor for banks that apply the IRB approach for credit risk (Article 164 of the CRR)

Competent authorities can set higher minimum values of exposure-weighted average LGD for exposures secured by property, on the basis of financial stability considerations. The exposure-weighted average LGD

for all retail exposures secured by residential property and not benefiting from guarantees from central governments must not be lower than 10%. LGD is only one of the parameters used in the risk-weight function. Increasing the LGD only indirectly increases the risk weight.

According to Eesti Pank, the lower risk weights for mortgage loans are the result of a fall in the probability of default (PD) rather than LGD estimates. In fact, average LGD rates have fallen less and are more homogenous across banks.

The ESRB is of the view that, given the narrower focus of Article 164, which only targets LGD and not PD, such a measure would not sufficiently address the intended purpose of the 15% risk-weight floor. In particular, it could even lead to unintended results by affecting banks' risk weights in a disproportionate manner, given that the IRB risk-weight formula is a linear function of the LGD parameter.

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

Member States may introduce a systemic risk buffer (SyRB) to address long-term, non-cyclical systemic or macroprudential risks not covered by the CRR. The SyRB can be applied to all banks or to a subset of banks. Additionally, the SyRB can be applied to domestic exposures, exposures in third countries and exposures in other Member States.

From 1 August 2016, all credit institutions are required to hold a systemic risk buffer of 1% of risk exposures located in Estonia. The SyRB addresses the long-term non-cyclical systemic risk stemming from the structural characteristics of the Estonian economy. The small size and openness of the Estonian economy makes it vulnerable to negative developments in the external environment. This risk is different from the risk targeted by the draft measure, which aims to address the declining resilience of credit institutions to residential real estate risk. The combination of two distinct risk sources in a single SyRB calibration could also adversely affect the transparency of the instrument, unless adequate communication tools were to be used.

The aim of the draft 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 pursuant to Article 133 would not allow any distinction to be made between the affected sectors. A measure applicable to all exposures would have an impact on sectors that are not subject to a specific risk, including, for example, lending to the corporate sector and SMEs.

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

The countercyclical capital buffer (CCyB) can be used to address some of the procyclicality in the financial system. The CCyB addresses cyclical risks and is based on the relationship between growth in total credit and GDP growth, and is a requirement applicable to domestic exposures. The CCyB rate is set on a quarterly basis by the designated authority. Designated authorities follow a specific methodology based on an

ESRB recommendation.¹¹ Eesti Pank has not identified excessive credit growth in the Estonian economy and decided on 25 March 2019 to keep the countercyclical capital buffer rate for credit institutions at 0% of the credit risk exposures located in Estonia.

The CCyB is not an appropriate tool for addressing systemic risk linked to a subset of exposures in Estonia and is not applicable only to a subset of institutions. The CCyB rate is applied as a percentage of the total amount of risk exposures calculated in accordance with Article 92(3) of Regulation (EU) No 575/2013. Therefore, it is not possible to apply the CCyB requirement to specific subsets of exposures – i.e. Estonian mortgage loans. Moreover, the CCyB would apply to all institutions in Estonia, while the measure targets only IRB credit institutions.

Furthermore, as the CCyB, like other macroprudential capital buffers, is calculated on the basis of the risk-weighted exposure amount, it is not an adequate tool for addressing risks related to the underestimation of risk weights. In fact, the application of the CCyB would not hinder a potential further decrease of risk weights, which would diminish the effectiveness of any CCyB in place and would require its additional increase.

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

Competent authorities can apply supervisory measures to address risks that are not sufficiently covered by Pillar 1, including systemic risks. These powers can be applied under the supervisory review and evaluation process (SREP), one of the components of Pillar 2. Furthermore, CRD IV currently allows the use of Pillar 2 in a similar or identical manner to institutions with similar risk profiles (Article 103 of CRD IV). It should be noted that the European legislator has recently decided to discontinue the macroprudential use of Pillar 2, with this decision taking effect two years from now.

Eesti Pank discussed the risk weights of IRB credit institutions with the European Central Bank (ECB)/Single Supervisory Mechanism (SSM). The ECB explained that the Targeted Review of Internal Models (TRIM) is underway and that the models in question had been included. The ECB does not see any need for additional microprudential action beyond that already underway in the context of the TRIM. According to the ECB, TRIM decisions are not calibrated to counter RRE risk that is macroprudential or systemic in nature.

At this stage, there are no grounds for activating Pillar 2 as a macroprudential tool. Given that the SREP process is mainly a microprudential assessment, since the proposed measure is motivated by macroprudential concerns arising from sectoral systemic risks related to RRE that cannot be sufficiently captured under Pillar 1, application of the measure established under Article 458 of the CRR remains warranted.

¹¹ Recommendation of the European Systemic Risk Board of 18 June 2014 on guidance for setting countercyclical buffer rates (ESRB/2014/1).

f) Using other measures

From 1 March 2015, all banks operating in Estonia have to comply with three requirements when issuing housing loans. These limits are an LTV limit of 85%, a DSTI limit of 50% and a maximum maturity for housing loans of 30 years.

While borrower-based measures per se are powerful tools, they apply to new loans only and thus solely affect the flow and not the stock of the RRE portfolio. Therefore, they cannot address the underestimation of risks that could result from a further decline in risk weights related to the stock of RRE exposures. Furthermore, Eesti Pank argues that the borrower-based measures introduced in 2015 were calibrated as a backstop on the basis of banks' actual loan terms and conditions, and there is no evidence of a causal link between these measures and the observed decrease in risks weights.

Section 4: Analysis of the net benefits of the measure

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

The draft measure is expected to contribute to the resilience of the Estonian banking system and therefore to potentially enhance the overall resilience of the economy as a whole, albeit to a modest extent. Eesti Pank estimates the total increase in risk-weighted assets to be €140 million (2.2%) and that the weighted average CET1 ratio of IRB credit institutions would decrease approximately by 0.8 percentage points. Compared with the actual weighted average CET1 ratio of 39.2% at the end of 2018, the impact is small. Notwithstanding the different impact on the capital ratios of individual banks, no IRB credit institution is expected to need to raise new capital following the proposed measure.

According to Eesti Pank, the measure will contribute to the resilience of Estonia's banking system, which is key to the proper functioning of the Estonian economy. The Estonian economy is a small open economy vulnerable to negative developments in the external environment, with a high degree of private sector dependence on financing from the banking sector and a banking sector with a high level of concentration in two IRB credit institutions. Therefore, Eesti Pank deems that, in order to avoid disruption in the supply of credit to the economy under negative macroeconomic scenarios, it is important to ensure that the capital buffers of IRB credit institutions are sufficient, through macroprudential backstops that go beyond microprudential standards. In particular, as residential mortgage loans account for a large share of the total exposure of Estonia's banking sector, if IRB credit institutions underestimate the systemic risks related to RRE lending, 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.

Eesti Pank did not provide information on the possible impact of the measure on economic growth. Nonetheless, given the limited change in capital requirements and its pre-emptive nature (backstop), the impact is

expected to be small. For the same reason, any impact on growth in other countries would also be expected to be minimal.

4.2 Effects on domestic and cross-border lending

Eesti Pank expects a limited impact on domestic and cross-border lending given that Estonia's IRB credit institutions are sufficiently capitalised. Eesti Pank also expects that the introduction of this measure will not limit or significantly influence lending by credit institutions to other economic sectors.

As the vast majority of Estonian mortgage retail loans are held by the IRB credit institutions, the likelihood of a material impact on cross-border lending is small. Eesti Pank estimates that 99% of Estonian mortgage loans held by IRB credit institutions have been issued in Estonia. Therefore, the impact on IRB credit institutions not based in Estonia is small. In addition, the two IRB credit institutions in Estonia are subsidiaries of EU institutions and their foreign exposures are limited. The market share of foreign branches has been substantially reduced in recent years following mergers and the withdrawal of a licence for one branch. According to Eesti Pank, the share of non-bank mortgage lending is also small. No elements have been presented by the Estonian authorities, nor any comments have been made by ESRB members, that suggest a negative impact for the internal market.

4.3 Effects on intragroup behaviour of credit institutions

Given that IRB credit institutions already meet the higher capital requirement, it is unlikely that the measure will cause a significant shift of operations within their group structures. Both IRB credit institutions are subsidiaries of credit institutions residing in the EU. However, the share of the Estonian subsidiaries in total assets of the whole group stands at only 5% and 2.5% respectively according to the banks' annual reports for 2018.

The development of cross-border mortgage lending and lending through branches should be monitored, as Eesti Pank does not intend to request reciprocation of the measure. In the absence of reciprocation, intragroup shifts in exposures could be possible in order to circumvent the measure. However, given that the parent companies of the banks concerned do not have authorisation to use IRB models for cross-border lending, this should act as a major obstacle to circumvention. Only the Estonian subsidiaries are authorised to use IRB models for Estonian exposures. Therefore, if parent companies were to engage in cross-border lending to households in Estonia, they would have to use the standardised approach for those exposures and that would

mean higher risk weights than the Estonian risk weight floor.¹² Further investigation of developments at the level of individual institutions (in particular by the supervisory colleges of the banking groups concerned) should be initiated in the event of significant intragroup activity regarding Estonian mortgage loans.

Conclusions

According to Eesti Pank, the main purpose of the draft measure is to limit further decreases in the risk weights applied to the IRB banks' portfolio of retail exposures secured by mortgages on immovable property to obligors residing in Estonia. This sets a macroprudential backstop yielding a higher level of resilience than is currently the case. By limiting a further decrease in risk weights, it should uphold the resilience of the banks and ensure that they hold sufficient own funds to cover systemic risks related to mortgage loans and the RRE market. If the risk weights were to decline further, capital buffers, which are calculated in terms of risk-weighted assets, would become less effective and, according to Eesti Pank, potentially insufficient if systemic risk were to materialise. Eesti Pank has also highlighted that, although the measure will have an immediate impact on risk weight levels at one institution, it has a broader, pre-emptive and forward-looking nature that is commensurate with its macroprudential purpose.

The ESRB has been monitoring RRE risks across Europe over the past few years. Estonia was not an addressee of an ESRB warning in 2016 and, in the light of the current developments, the ESRB is currently not preparing a warning or a recommendation to the authorities of the country. Nevertheless, it is noted that the vulnerabilities related to the residential real estate market have not decreased in the recent past and that vulnerabilities in the household sector are material. Eesti Pank also highlights that risks related to household indebtedness could be underestimated owing to the volatile nature of economic growth in Estonia. Therefore, while risks in the RRE sector have neither markedly increased nor decreased, a decrease in the risk weights of the relevant IRB institutions per se causes a reduction in the resilience to systemic risk.

The ESRB is therefore of the view that the planned measure may help to maintain the capacity of the capital in IRB credit institutions in Estonia to mitigate a possible materialisation of systemic risk in the real estate market. The information provided by Eesti Pank highlights that risk weights have been decreasing, while risks related to the real estate sector have not. Although microprudential risks to the credit institutions in question will be addressed by the competent authority through ongoing assessment and actions, this work does not aim to deliver a minimum average risk weight to provide additional systemic safeguards of the type envisaged by Eesti Pank. The precondition for activating Article 458 of the CRR involves the identification of "changes in the intensity of macroprudential or systemic risk in the financial system with the potential to have serious negative

¹² This is also applicable for lending extended by other Baltic subsidiaries in Lithuania and Latvia. Their authorisations to use IRB models are country-specific.

consequences to the financial system and the real economy in a specific Member State". While systemic risks related to the RRE sector in Estonia have not decreased over recent years, the measure can be interpreted as having a pre-emptive nature, i.e. aimed at ensuring that banks hold sufficient own funds to cover systemic risks, should they materialise, and preventing a substantial decrease in the resilience of institutions.

The ESRB is further of the view that the alternative macroprudential instruments listed in Article 458 of the CRR, which must be considered before any stricter national measure can be taken, would not be appropriate to address the risk at hand. Measures such as those listed in Articles 124 and 164 of the CRR, as well as the systemic risk buffer (Article 133 of the CRR) or the countercyclical capital buffer (Article 136 of the CRR), are considered inappropriate as they do not provide the intended incentives, are too broad-based, or do not address the relevant type of risk, exposure or credit institutions.

Regarding the use of Pillar 2 as a possible alternative in terms of adequacy and relative effectiveness, the competent authority explained to Eesti Pank the procedures underway. These do not currently give rise to a need to use Pillar 2 to align minimum risk weights, as this is driven by concern over the systemic nature of the market rather than risk to individual institutions. It should be highlighted that, in the specific case of Estonia, the intervention is motivated by macroprudential concerns which cannot be sufficiently captured by the SREP process, which is mainly a micro-prudential assessment. Therefore, a national macroprudential measure might be warranted.

Overall, the ESRB considers that the measure would not entail disproportionate adverse effects for the internal market or other financial systems. The draft measure would prevent a further decline in the risk weights applied by IRB credit institutions to the portfolio of Estonian mortgage loans and its further deviation from the levels applied in other Member States. Also, by keeping the risk weight floor relatively low compared with other EU Member States, this should not have a disproportionate adverse effect on the Single Market and could even be seen as levelling the playing field to some degree.

From a wider perspective, this assessment highlights the importance of the harmonised supervision of internal models at the European level, also in view of their dispersion across regions and countries. From a macroprudential perspective, such an inconsistent approach to supervision could raise two issues, which go beyond the current case. First, lower average risk weights in some countries could raise the issue of adequate loss coverage in bad times. Second, all macroprudential capital charges are directly linked to the risk weight levels. Any underestimation of risk weights decreases, *de facto*, the efficiency of macroprudential capital buffers, while a reciprocation of certain buffers (which in this case is not advocated by the Estonian authorities) could have unintended effects owing to the difference in risk weights between one country and another. By promoting the harmonised supervision of internal models, exercises such as TRIM should also prove beneficial from a macroprudential policy perspective.