ESRB
European Systemic Risk Board
European System of Financial Supervision

Assessment of the Finnish notification of an extension of the period of application of a stricter national measure for residential real estate lending based on Article 458 of Regulation (EU) No 575/2013

Introduction

On 28 June 2019 Finanssivalvonta (FIN-FSA, the Finnish Financial Supervisory Authority) notified the European Systemic Risk Board (ESRB) of its decision to retain a credit institution-specific minimum level of 15% for the average risk weight on housing loans by credit institutions that have adopted the Internal Ratings Based Approach, with effect from 1 January 2020, in accordance with Article 458(9) of the Capital Requirements Regulation (CRR).[1] The FIN-FSA's decision of 28 June 2019 extends the period of application of its earlier decision of 26 June 2017 by one year, while not changing the substance of the national measure.

Pursuant to Article 458(4) of the CRR, referred to by Article 458(9) of the CRR, the ESRB must 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 procedural framework for the provision of opinions under Article 458 of the CRR is clarified in Decision ESRB/2015/4[2].

The ESRB issued its Opinion of 19 July 2017 (ESRB/2017/3) on the previous notification of the FIN-FSA, which was accompanied by an assessment. Opinion ESRB/2017/3 was published on 30 August 2017, together with a report assessing the national measure.[3] In addition, following a request by the FIN-FSA to the ESRB under Article 458(8) of Regulation (EU) No 575/2013, the General Board of the ESRB decided to include this stricter national measure in the list of macroprudential policy measures which are recommended for reciprocation under Recommendation ESRB/2015/2 of the European Systemic Risk Board[4].

[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] 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.

[3] See: **https://www.esrb.europa.eu/mppa/opinions/html/index.en.html**

[4] Recommendation ESRB/2015/2 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 (OJ C 97, 12.3.2016, p. 9).

The ESRB's current assessment builds on its assessment in 2017 of the original national measure, focussing on the net benefits of the national measure for maintaining financial stability. Thus, the assessment of 2017 forms an integral part of the present reassessment and the current assessment should therefore be read in conjunction with the earlier one. In particular, the ESRB has assessed and confirms its assessment of the rationale for 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)[5] and the CRR adequately and appropriately address the risk, taking into account their relative effectiveness?
- **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. have 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 also draws on the information provided by, and discussions with, the FIN-FSA and its staff.

Section 1: Description of and background to the measure

1.1 Description of the measure

The present decision of the FIN-FSA consists of an extension of the period for the application of a credit institution-specific minimum level of 15% for the average risk weight on housing loans by credit institutions that have adopted the Internal Ratings Based Approach ("IRB credit institutions"). The extension will apply from 1 January 2020 until 31 December 2020. The original measure underlying this extension decision had been adopted by the FIN-FSA on 26 June 2017 and applied from 1 January 2018 until 31 December 2019.

[5] 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).

The extension of the period for the application of the existing risk weight floor of 15% on housing loans for IRB credit institutions is motivated by the FIN-FSA's assessment that changes in the intensity of macroprudential and systemic risk in the financial system remain, which have the potential for serious negative consequences for the financial system and the real economy. The FIN-FSA had already identified such changes in 2017, when it deemed that they would be best addressed by means of the risk weight floor of 15%.

1.2 Background to the measure

The Finnish national authorities had introduced a number of other macroprudential measures before the current risk weight floor of 15%. By 2016, legally binding loan-to-collateral (LTC) limits had been introduced, the tax deductibility on mortgage interest payments was gradually being removed, and there were plans to strengthen capital adequacy requirements for mortgage exposures, as well as for an early introduction of other capital-based measures. However, apart from the powers over the loan-to-value (LTV)/LTC ratio, the national authorities lacked legally-binding powers over other borrower income-based ratios which would be more efficient in curbing the increase in the indebtedness of households, such as the loan-to-income (LTI), debt-to-income (DTI) and debt service-to-income (DSTI) ratios.

Since then, the national authorities have tightened or introduced several borrower-based and capital measures. Besides the 15% risk weight floor decided in 2017 and applicable as of 2018, a Systemic Risk Buffer (SyRB) of between 1% and 3% was imposed for several institutions in 2018. To mitigate the vulnerabilities related to household indebtedness, the LTC limit for housing loans other than first-home loans was tightened to 85% in July 2018. Recently, the FIN-FSA Board has also issued recommendations concerning lending standards for new loans, which are also aimed at the housing loans provided by housing companies. Finally, the tax deductibility of mortgages has been reduced (from 100% in 2011 to 25% in 2019).

Section 2: Analysis of the underlying systemic risks

The ESRB considers that the key vulnerabilities of the Finnish residential real estate sector are related to (i) elevated and rising household indebtedness, (ii) the significant proportion of housing loans in the portfolio of Finnish credit institutions and the high growth in indirect real estate lending to households through housing company loans, (iii) the easing of lending standards for new loans, and (iv) the interconnectedness with the rest of the Nordic banking system. These vulnerabilities have not decreased since 2017. Finland's residential real estate vulnerabilities were recently assessed by the ESRB as part of a systematic and forward-looking exercise that covered the European Economic Area (EEA).[6] This assessment revealed elevated and rising household indebtedness in Finland, which is now higher than in 2016. Recently, this increase has been partly driven by loans to housing companies, which are growing rapidly (10% annual growth rate) and are in practice paid back by households and other investors holding the shares of these companies. In addition, an easing of lending standards for new loans was observed, and it was noted that the Finnish banking system is strongly interconnected with the banking systems of other Nordic countries, which can lead to spillovers of 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 and conducted a Union-wide assessment of the vulnerabilities relating to residential real estate in 2016. This assessment enabled the ESRB to identity a number of medium-term vulnerabilities in several countries as sources of systemic risk to financial stability, which led to warnings being issued to eight countries, of which Finland was one. In 2016 the main vulnerability identified in the residential real estate market in Finland was high and increasing household indebtedness, with a significant share of households being potentially vulnerable to adverse economic or financial conditions or adverse developments in that market. More than a quarter of household debt was concentrated among 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.

2.1 Vulnerabilities in the residential property sector

Currently, there is no evidence of house price overvaluation, but house prices have diverged regionally over the past decade, particularly between the Helsinki metropolitan area and the rest of the country. Tax deductibility of mortgages was an incentive for house purchases, but it has recently been reduced (from 100% in 2011 to 25% in 2019). Housing prices have not been increasing recently, so forward-looking concerns about overvaluation are fairly contained at the moment. Also, the FIN-FSA assesses that since 2010 developments in real house prices have been more moderate than previously. They consider, however, that there is currently a risk of regional price overvaluation. Notably they point out that regional differences in house price developments increase the risk of local house price overvaluations and their potential negative consequences, with house prices in urban growth centres having increasingly and significantly diverged from those in the rest of the country.

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6 See ESRB General Board 34th meeting press release:
https://www.esrb.europa.eu/news/pr/date/2019/html/esrb.pr190407~7afb3fadc6.en.html

2.2 Vulnerabilities in the household sector

In line with the ESRB assessment, the FIN-FSA considers that recent developments in housing lending and housing markets have increased the intensity of systemic risks and the threats these pose to financial stability. The FIN-FSA in particular points out that the structure of household debt has become more fragile due to the fast growth in housing company loans, which involve risks that are less transparent than those of traditional housing loans. In addition, longer maturities lead to slower amortisation.

Household indebtedness is elevated and relatively high by international comparison (household debt stood at around 129.3% of disposable income in Q1 2019)[7], and has increased over the medium term. The largest share of mortgages (more than 97% according to the FIN-FSA) is made up of variable interest rate loans, which makes borrowers vulnerable to shocks to the market interest rates. A large share of housing loans is held by highly indebted borrowers; hence, the distribution of debt among households is very uneven. As a mitigating factor, however, mortgages in Finland have relatively short maturities and are also fully amortising.

2.3 Vulnerabilities in the banking sector

The Finnish banking sector is vulnerable to a downturn in real estate markets. Housing loans make up a significant proportion of the loans granted by Finnish credit institutions. In addition, lending to non-financial corporations (NFCs) is highly concentrated in the construction and real estate sectors (including housing company loans) – the highest concentration seen in any European country. Furthermore, housing loans are highly concentrated among IRB credit institutions. Moreover, Finnish banks are highly dependent on market financing, mainly consisting in covered bonds collateralised by residential housing loans they have granted, which makes them vulnerable to shocks to investor sentiment.

The vulnerabilities of the Finnish banking sector related to real estate exposures have increased recently, due to an easing of lending standards for new loans. There has been fast growth in housing company loans, which are less transparent than standard household loans. There has also been an easing of lending standards for new loans: (i) the average maturity of housing loans has been increasing, which potentially increases banks' loss given default; (ii) narrower interest margins on new housing loans by banks are also decreasing their loss absorption capacity.

The current favourable macroeconomic environment is likely to also translate into better quality of the portfolio and thus lower risk weights calculated using the IRB approach. While valid from the microprudential perspective, risk weights may not sufficiently take into account the systemic vulnerabilities stemming from housing markets, household indebtedness and housing lending. The result may be to amplify

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[7] Source: Financial accounts, Statistics Finland, **http://tilastokeskus.fi/til/rtp/2019/01/rtp_2019_01_2019-06-28_tau_002_en.html**

shocks from the housing markets and increase the second round effects of such shocks and crises on banks and the overall economy.

Furthermore, the Nordic financial system's large size and the high degree of concentration and interconnectedness across the region all add to the vulnerabilities faced by the financial sector.

Section 3: Effectiveness and efficiency of the measure

3.1 How the measure addresses the risk identified

The measure is designed to address the problem that the risk weights for housing loans by IRB credit institutions are insufficient to cover the negative impact of a systemic residential real estate market crisis. From a macroprudential perspective, the floor prevents declines in risk weights throughout the system. In light of the system-wide risk inherent in the residential real estate market, this safeguards the effectiveness of the capital ratios. It ensures that the banks have sufficient additional capital to cover any loan losses resulting from a severe financial crisis. The FIN-FSA notably points out that since the identified macroprudential and systemic risk involves the market as a whole, it is appropriate to address the risk through a market-wide macroprudential measure.

The extended measure is part of a wider set of existing capital and borrower-based measures introduced or tightened since 2016 to address risks in the Finnish banking and residential real estate (RRE) sector. Besides the average risk weight floor of 15% for housing loans granted by IRB credit institutions, which has applied since January 2018 and of which the current measure is an extension, the Finnish national authorities have tightened or introduced several borrower-based and capital-based measures. In 2018 a systemic risk buffer of between 1% and 3% was imposed on all credit institutions. In 2018 the limit that applies to the LTV ratio was tightened from 90% to 85%. Furthermore in 2018, the FIN-FSA issued recommendations concerning lending standards for new loans, which also applied to loans to housing companies. In addition, the tax deductibility of mortgage interest expenses was reduced, from 100% in 2011 to 25% in 2019.

In line with its 2017 assessment, the ESRB deems the extended measure to be effective in achieving its intended objective, namely targeting potential asset bubbles in the RRE sector by strengthening the resilience of the banking sector. As also pointed out by the FIN-FSA, the reasons why the elevated systemic risks may pose a threat to financial stability in Finland remain in principle the same as they were in 2017 when the initial risk weight floor was decided, and the extension of the measure will continue to ensure a minimum level of risk weight density and thus resilience of the banks.

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)

In line with its 2017 assessment, the ESRB considers that Article 124 of the CRR would not be effective in meeting the measure's objectives. This is because it does not apply to credit institutions that use the IRB approach.

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

In line with the 2017 assessment, the ESRB is of the view that, given the narrower focus of Article 164, which only targets LGD and not probability of default (PD), such a measure would not sufficiently address the intended purpose of the 15% risk weight floor. For IRB banks, the competent authority may, under Pillar 1 of the CRD IV/CRR, increase the exposure-weighted average 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 (alongside the PD). Increasing the LGD level indirectly increases the risk weight and capital requirements.

The macroprudential rationale underpinning the measure is not related to the low LGD values. In addition, according to an assessment run by the FIN-FSA and Suomen Pankki – Finlands Bank, increasing the minimum LGD level by applying Article 164 of the CRR would result in a (potentially disproportionate) increase in risk weights for some banks that currently have a high or average level of risk weights.

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

The aim of the extended measure of a 15% risk weight floor is to ensure that the capitalisation of IRB credit institutions is sufficient to safeguard them against risks stemming from domestic housing loans. The current application of the systemic risk buffer pursuant to Article 133 would not allow any distinction to be made between the affected sectors, so that it would not be possible to target RRE risks. 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. In addition, the FIN-FSA sees difficulties under Finnish law in specifically targeting IRB banks. Importantly, the FIN-FSA assesses that achieving the same impact via the SyRB as can be achieved by the risk weight floor would require higher SyRB rates than are currently possible given the limits of 3.0% and 5.0% under Finnish legislation.

The FIN-FSA acknowledged the need to reassess the present risk weight floor once the amendments to the Capital Requirements Directive and Regulation (CRD V and CRR II) have entered into force. These amendments will enable the use of a sectoral SyRB applicable to retail exposures to natural persons secured by residential property. While such a sectoral application of the SyRB will make it possible to specifically target the risks of the residential real estate sector, it will still be necessary to assess to what extent a risk weight floor may be needed as a complement in order to avoid an erosion of risk weights due to model optimisation. This assessment will notably have to take account of the fact that the risk weights are the basis for calculating all capital requirements and buffers, so that a decline in risk weights has a significant impact on the intrinsic value of capital levels.

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

In line with the 2017 assessment, the ESRB is of the view that setting a countercyclical capital buffer (CCyB) would not sufficiently address the intended purpose of the 15% risk weight floor. The CCyB is intended to address cyclical risks, whereas the FIN-FSA aims to use the risk weight floor to address structural risks. Moreover, the CCyB would apply to all Finish exposures, not only residential real estate lending.

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

In line with the 2017 assessment, the ESRB is of the view that using Pillar 2 measures would not constitute an equivalent alternative to the 15% risk weight floor. In line with the FIN-FSA's assessment, while existing IRB models are based on valid statistical microprudential data, they do not take into account the additional systemic risk deriving from the overall high level of mortgage lending, notably in light of the high household indebtedness and the easing of lending standards. The macroprudential dimension of the overall low risk weights therefore justifies a macroprudential response in the form of an overall floor. In addition, the FIN-FSA rightly points out that in contrast to measures under Article 458 of the CRR, for Pillar 2 measures there is no explicit legal foundation for reciprocation, which reduces their overall effectiveness in an interconnected market.

f) Using other measures

In line with the 2017 assessment, the ESRB highlights that given the concerns expressed by the ESRB warning about the high and increasing level of household indebtedness being the main medium-term vulnerability for the RRE sector, it also seems warranted to strengthen the banking sector or introduce measures to address this vulnerability more directly.

While borrower-based measures are themselves powerful tools, they only apply to new loans and thus solely affect the flow and not the stock of the RRE portfolio. Therefore, they cannot address the aggravation of macroprudential risks related to the stock of existing residential real estate exposures.

Section 4: Analysis of the net benefits of the measure

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

In line with the 2017 assessment, the draft measure is expected to continue contributing to the resilience of the Finnish banking system and therefore to potentially enhance the resilience of the economy as a whole, albeit to a modest extent. According to the FIN-FSA's assessment, the effects of the measure in place since 2018 and its extension are suitable, effective and proportionate. Notably the FIN-FSA points out that the measure is aimed at strengthening the banking sector and ensuring its resilience to asset bubbles at an early stage. The ESRB shares this assessment, particularly in light of the need, from a macroprudential perspective, to ensure a minimum level of resilience in the banking sector as a whole. Given that all capital requirements, including buffer requirements, are expressed in terms of risk-weighted assets, it is of the essence that risk weights are calculated in a prudent manner which preserves the real value of capital. The existing risk weight floor and its extension serve this purpose.

4.2 Effects on domestic and cross-border lending

The FIN-FSA expects limited effects on domestic and cross-border lending and, especially given the past experience with the existing 15% risk weight floor, the ESRB sees no indication that the extension of the measure would have any material impact. Overall, the FIN-FSA assesses the impact of the measure on the Internal Market to be positive, given that it increases the resilience of the Finnish banking sector, implying more stability, which is beneficial to the functioning of the market.

4.3 Effects on the intragroup behaviour of credit institutions

In line with the 2017 assessment and in light of the experience to date with the existing 15% risk weight floor, the ESRB has no indication that the extension of the measure would have any material impact on intragroup behaviour. Given that the floor is already in place, it is not expected that the measure will cause a significant shift of operations within the group structures of credit institutions.

Conclusions

The ESRB confirms its 2017 assessment of the minimum level of 15% for the average risk weight on housing loans by credit institutions that have adopted the Internal Ratings Based Approach, and welcomes its extension by one year. In the FIN-FSA's assessment – which the ESRB shares – recent developments in housing lending and housing markets have increased the intensity of systemic risks and the threats they pose to financial stability. The ESRB considers that the key vulnerabilities of the Finnish residential real estate sector are related to: (i) elevated and rising household indebtedness, (ii) the significant proportion of housing loans in the portfolio of Finnish credit institutions and the high growth in indirect real estate lending to households through housing company loans, (iii) the easing of lending standards for new loans, and (iv) the interconnectedness with the rest of the Nordic banking system. The change in the intensity of systemic risk warrants the continuation of macroprudential action.

The ESRB has been monitoring risks related to the RRE sector in all EU Member States over the past few years. In its Warning of 22 September 2016[8], the ESRB considered the main medium-term vulnerabilities in the

[8] Warning of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of Finland.

RRE sector in Finland to be the high and increasing level of household indebtedness, with more than a quarter of household debt being concentrated among a relatively small group of highly indebted households. The ESRB further mentioned that if risks were to materialise, there could potentially be spillover effects to other countries in the Nordic-Baltic region.

The ESRB is continuing its monitoring and recently considered the medium-term risks related to vulnerabilities in the EEA RRE sector. The ESRB risk and policy assessment aimed to identify the main trends in various risk indicators across the RRE sector in the EEA countries, and the respective macroprudential policy action that these countries have taken or may still need to take in order to mitigate the financial stability risks identified.

In its 2017 assessment, the ESRB called for follow-up action on a number of issues, which to a large extent has been taken and therefore do not pose any impediment to the present extension of the measure. First, the ESRB had called for close monitoring of whether the measure effectively increased the resilience of the banking sector in light of the reaction of the targeted banks, notably cautioning against a potential reduction in their voluntary capital buffers. No such unwarranted reaction was observed. Second, the ESRB had called for coordination between European supervisory authorities. According to the FIN-FSA, coordination between them and the ECB in its capacity as banking supervisor took place, which made it possible to take an informed macroprudential decision in the light of the ongoing microprudential supervision. Third, the ESRB was of the opinion that consideration should be given to using the SyRB once available in Finnish law. Given that the SyRB has now been introduced in Finland, the FIN-FSA rightly assessed the possibility of its use, but concluded that it would not meet the policy objective to the same extent (see Section 3.2(c) above). Fourth, the ESRB pointed out the need to consider income-based instruments, which could more directly address the high and increasing level of household indebtedness. The ESRB wishes to highlight that these are still valid considerations which should be taken into account in future policy action. At the same time, the ESRB concurs with the FIN-FSA that such borrower-based measures would only target new mortgages, while the risks inherent in the high stock of household debt would not be addressed. Thus, the extension of the risk weight floor remains a valid means to address these stock-related risks. Fifth, the ESRB pointed out the need to further increase the effectiveness of the existing LTV cap. In 2018, the existing LTV ratio was tightened from 90% to 85%; however, it is still defined in a manner that allows assets other than real estate assets to be considered as collateral, which may provide scope for circumvention. Sixth, the ESRB had called for monitoring of the extent to which the measure was reciprocated, and the FIN-FSA has pointed out that the other Nordic countries have indeed reciprocated the risk weight floor.

Overall, the ESRB considers that extending the measure would not entail disproportionate adverse effects for the Internal Market or other financial systems. The extension would continue to prevent a decline in the risk weights applied by Finnish IRB credit institutions to the portfolio of housing loans and its further deviation from the levels applied in other Member States. Also, keeping the risk weight floor relatively low compared with other EU Member States 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, the importance of harmonised supervision of internal models at the European level should be highlighted, also in view of the dispersion of risk weights across EU regions and countries. From a macroprudential perspective, an inconsistent approach to supervision could raise two issues, which are of a much broader nature than the case at hand. First, lower average risk weights in some countries which are not justified by the risk profile of the underlying assets could raise the issue of adequate loss coverage in bad times from a system-wide perspective. Given that all capital requirements are expressed in terms of risk-weighted assets, it is of the essence that risk weights are calculated in a prudent manner which preserves the real value of capital. Second, all macroprudential capital charges are directly linked to the risk weight levels. Any underestimation of risk weights de facto decreases the efficiency of macroprudential capital buffers, while a reciprocation of certain buffers could have unintended effects owing to the difference in risk weights between countries. By promoting the harmonised supervision of internal models, exercises such as the targeted review of internal models (TRIM), which addresses the variability of non-risk based risk weighted assets, should also prove beneficial from a macroprudential policy perspective.