



Assessment of the Dutch 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 8 January 2020 De Nederlandsche Bank 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. De Nederlandsche Bank is the designated authority responsible for the application of Article 458 of the CRR in the Netherlands.² The draft measure imposes, on credit institutions that use the Internal Ratings Based (IRB) approach for calculating regulatory capital requirements (hereinafter IRB banks), a minimum average risk weight to the portfolio of exposures to natural persons secured by mortgages on residential property located in the Netherlands. Loans covered by the Dutch National Mortgage Guarantee (NHG) scheme will be exempt from the measure. The proposed measure primarily aims to enhance the resilience of Dutch banks to a potential severe downturn in the housing market, in the context of sustained real estate price increases in recent years.

Pursuant to Article 458(4) of the CRR, the ESRB must provide the EU Council, the European Commission and the Netherlands 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 providing 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?
- **Effectiveness:** is the measure likely to achieve its intended objective?

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 **Section 3:66 of the Dutch Financial Supervision Act**, De Nederlandsche Bank 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).

- 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?

The ESRB's assessment draws on the information provided by De Nederlandsche Bank, in addition to discussions with the bank and its staff.

Section 1: Description of and background to the measure

1.1 Description of the measure

The draft measure imposes a minimum average risk weight for IRB banks' portfolio of exposures to natural persons secured by mortgages on residential property located in the Netherlands. The minimum average risk weight of the portfolio is the exposure weighted average of the risk weights of the individual loans, whereby the risk weight of each individual exposure item in scope of the measure is either: (i) 12% if the LTV is less than 55%, or (ii) the weighted average of a 12% risk weight assigned to the portion of the loan not exceeding 55% of the market value of the property securing the loan, and a 45% risk weight assigned to the remaining portion of the loan.

The measure consists of a risk sensitive floor to risk weights, as it differentiates the average minimum risk weight of the portfolio based on the loan to value (LTV) of the mortgage. Risk weights of the individual loans increase with the LTV ratio of the loans: from 12% for loans with an LTV ratio up to 55% to 26.85% for loans with an LTV ratio of 100%. The LTV ratio to be used in this calculation should be determined in accordance with the applicable provisions of the CRR. The LTV ratio is updated by banks regularly, typically with a quarterly frequency.

The measure applies to exposures of IRB banks to natural persons secured by mortgages on residential property located in the Netherlands and not wholly or partly covered by the NHG.⁵ The measure targets only IRB banks' portfolios given that (i) IRB banks account for 96% of all mortgage lending by banks in the Netherlands and (ii) risk weights under the standardised approach are higher than the average risk weight resulting from the intended risk weight floor. NHG mortgages account for 20-25% of the banks' mortgage portfolios and therefore they can also contribute to systemic risk (owing to indirect effects on consumer spending but also to a potential sovereign-bank nexus). Because these exposures benefit from a guarantee by a government-backed foundation, De Nederlandsche Bank considers them to be safer than non-NHG mortgages

⁵ The NHG scheme is a guarantee provided by a government-backed foundation, the Homeownership Guarantee Fund (Waarborgfonds Eigen Woningen, WEW), which covers 90% of the residual debt if a forced sale of the house is inevitable owing to circumstances beyond the control of the borrower (job loss, becoming disabled, divorce). The amount guaranteed under the NHG decreases over time on the basis of an annuity scheme.

and they have, therefore, been excluded from the scope of the proposed floor. However, because NHG loans can still have a systemic impact, De Nederlandsche Bank took all average risk weights, including for mortgages covered by the NHG into account, when calibrating the measure.

The proposed measure is scheduled to enter into force six months after it is published, and to remain in force for a period of two years. It will be introduced by announcement in the Dutch Government Gazette, which is intended to take place by March 2020. No phasing-in is planned. It is intended that the measure will come into force by September 2020, remaining in force for two years; it might be renewed after this period.

De Nederlandsche Bank intends to request reciprocation of the draft measure by other Member States, under Article 458(8) of the CRR – De Nederlandsche Bank will propose an institution-level maximum materiality threshold. It justifies this request with concerns that other Member States' banking sectors may be exposed to the systemic risk in the Dutch housing market, either directly or indirectly, through branches. It also argues that such reciprocation will contribute to a level playing field.

Article 458(10) of the CRR does not apply to the measure, as the increase in average risk weights is expected to be higher than 25%. According to De Nederlandsche Bank's calculations, the proposed measure is expected to increase targeted banks' average risk weights from 11% to between 14% and 15%⁶, constituting an increase of around 30%.

1.2 Background to the measure

The proposed measure primarily aims to enhance Dutch banks' resilience to a potential severe downturn in the housing market in the context of sustained price increases in real estate in recent years. De Nederlandsche Bank finds that current risk weights assigned to Dutch mortgage loans, which are among the lowest in the EU, do not accurately reflect the high and persistently increasing systemic risk in the housing market.

In September 2019 the ESRB issued a recommendation to the Dutch authorities to take further measures aimed at mitigating risks in the housing market.⁷ Already in 2016 the ESRB had issued a warning to the Netherlands, which mainly concerned high mortgage indebtedness, very high LTV ratios and high numbers of mortgages for which the debt owed exceeds the value of the home.⁸ While acknowledging that measures have been taken to address the risks since this warning was issued, the ESRB considered that further action was still warranted given that risks had increased due to sharp rises in house prices in recent years. Therefore the ESRB recommended: a) the establishment, in Dutch law, of an 'act or explain' mechanism in relation to recommendations issued by the macroprudential authority on the activation of legally binding borrower-based

⁶ As a result of the increase in risk weighted assets, the total amount of capital that IRB banks need to hold to meet the capital requirements is estimated to increase by around €3 billion, of which more than €2 billion is CET1-capital.

⁷ See [Recommendation of the European Systemic Risk Board of 27 June 2019 on medium-term vulnerabilities in the residential real estate sector in the Netherlands \(ESRB/2019/7\), 2019/C 366/04 OJ C 366, 30.10.2019, p. 22.](#)

⁸ See [Warning ESRB/2016/10 of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of Netherlands \(OJ C 31, 31.1.2017, p. 53\).](#)

measures; (b) the tightening of the existing legally binding limit that applies to the LTV ratio; (c) an amendment to the methodology for determining the maximum limit that applies to the debt-service-to-income ratio; (d) the activation of capital-based measures in order to ensure the resilience of the banking sector in relation to the medium-term vulnerabilities identified in the Netherlands. This recommendation also aims to emphasise the need for broader policy action to curb factors which facilitate or promote increasing household indebtedness.

In the view of the ESRB the current policy mix is not entirely sufficient to mitigate the existing vulnerabilities related to the residential real estate (RRE) market.⁹ The Dutch authorities had already introduced borrower-based measures targeting RRE, and capital measures targeting the biggest banks but these are considered insufficient. The LTV limit for mortgages in the Netherlands is currently at 100%, which is considered very high in absolute terms, relative to the degree of overvaluation and when compared to that of other countries.¹⁰ The loan-to-income (LTI) limit for mortgages in the Netherlands is a function of the household income and the mortgage interest rate, which might show procyclical behaviour, as changes in household income influence the limit¹¹. Bigger banks, which are usually the ones applying the IRB approach, have to hold a systemic risk buffer (SyRB). However, the SyRB is calibrated for various risks and might potentially incentivise banks to grant more real estate loans than other loans, since these typically have lower risk weights compared with other retail and corporate loans.¹²

Section 2: Analysis of the underlying systemic risks

In recent years, the ESRB has been monitoring risks related to the RRE sector in the Netherlands as well as in all other EU Member States. In 2016, the ESRB issued a warning to the Netherlands, which mainly concerned high mortgage loan indebtedness, very high LTV ratios and the significant share of mortgagors having total debt exceeding the value of their home (commonly referred as “underwater mortgages”). In June 2019, the ESRB issued a recommendation, pointing out that, despite measures taken, risks have increased as a result of sharp house price rises in recent years. Since 2016 house prices have continued to increase, leading to pockets of overvaluation in the major cities. Against this background, the LTV ratios of new mortgage loans have remained high, in particular because the regulatory limit of 100% that applies to LTV ratios does not require additional collateral if house prices decrease. Moreover, the vulnerabilities posed by these financial stability developments have not been reflected in the microprudential application of risk weights for mortgage loans in the Netherlands, which are among the lowest in the European Economic Area (EEA).

⁹ For more details see “**Vulnerabilities in the residential real estate sectors of the EEA countries**”, ESRB, September 2019.

¹⁰ The LTV limit was gradually reduced from 106% in 2012 to 100% in 2018 but, despite a recommendation from the Dutch Financial Stability Committee, there is currently no expectation that the Government, as holder of the legally binding powers to implement such measures, intends to lower the LTV limit further.

¹¹ At the average current mortgage interest rate, the LTI limit ranges from 3.5 for the lowest income groups to 5.5 for the highest income groups.

¹² Five Dutch banks that are systemically important are currently required to maintain an additional macroprudential buffer. This is 3% for ING Bank, Rabobank and ABN AMRO Bank, while it is 1% for Volksbank and BNG Bank and is at the highest of the G-SII buffer, the O-SII buffer and the systemic risk buffer.

The following sections provide further details on the assessment of vulnerabilities, including 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 RRE sector

After a correction phase, the Dutch housing market has regained its momentum in recent years supported, in part, by sluggish supply and declining interest rates. After a correction phase of the earlier market exuberance which lasted from 2008 to 2013, house prices have gone up sharply for several years in a row – by almost 8% annually on average in the past three years. This development has been fuelled by the low interest rate environment as well as structural factors, such as supply constraints and tax benefits on house purchases. Indeed, tax deductibility of interests paid on mortgages may incentivise households to over-borrow. At the same time, strict zoning regulations and scarcity of space (mainly in and around cities) have resulted in a low elasticity of the housing supply. As a result of the financial crisis, the capacity of the construction sector is currently limited – this is expected to continue suppressing the supply of new houses in the medium term.

Persistent house price growth has led to pockets of overvaluation, particularly in the capital and other large cities. In the Netherlands' major cities, real prices are now more than 17% above the previous peak level. Authorities have observed a spillover effect from the major cities, with prices in the surrounding regions also rising sharply. In the provinces of Noord-Holland, Zuid-Holland, Utrecht and Flevoland – which together account for 44% of all Dutch owner-occupied residential properties – real prices hover around the previous peak. Symptoms of overvaluation can also be observed in riskier behaviour, such as overbidding, on the part of buyers. As De Nederlandsche Bank reports, the share of transactions in which the purchase price exceeded the asking price has further increased to upwards of 60% in the four major cities and nearly 40% in the Netherlands overall.

In recent years, systemic risk in the Dutch RRE market has intensified considerably with price increases significantly outpacing income growth and house buyers borrowing ever larger amounts. Cumulated housing price growth over the past five years has substantially surpassed the growth in household income. As a result, price/income ratios in the major cities are now higher than at the peak of the previous housing market boom. Because residential properties are becoming more expensive both in absolute and relative terms, the average size of new loans has increased, thus keeping the level of household indebtedness extremely high. As De Nederlandsche Bank reports, while house buyers put up more of their own money, they also tend to borrow more in relation to their income. This contributes to the surge in financing charges (principal repayments and interest payments net of tax relief), which have gone up despite low interest rates. Charges for a fully annuity-based mortgage loan have returned to near pre-crisis levels. All these factors increase the level of systemic risk and exacerbate the possible negative consequences of a potential downward correction in the housing market.

2.2 Vulnerabilities in the household sector

Dutch household indebtedness is among the highest in Europe and the share of new loans with LTI ratios close to the regulatory limit has increased over the past few years. Mortgage debt of households is currently

at 91% of GDP and households' total indebtedness is at almost 102% of GDP (while the euro area average mortgage loan indebtedness is 55% of GDP). It seems Dutch households are still willing to borrow even larger amounts as indicated by the rise in the number of loans close to their LTI limit. This holds for loans both to first-time buyers and to home movers. The share of new loans with an LTI close to their LTI limit has risen steadily over the past few years. In the second quarter of 2019 almost 50% of all loans to first-time buyers were at or above 90% of the limit, while in 2014 this was the case for about 40% of these loans. For home movers, a similar situation has been observed with nearly 40% of their loans at or above 90% of the limit in the second quarter of 2019, against some 25% in 2014. Roughly two-thirds of the new loans to first-time buyers have an LTV ratio at or above 90%, and almost 40% have an LTV of 100% or more. In the event of a downward correction in house prices, many borrowers with high mortgage loans will have higher principal than the market value of their home, and are likely to considerably reduce their consumption.

Households' vulnerability may be amplified by the presence of variable interest rates and by a large share of interest-only loans. Of all the new loans in 2017, 15% were characterised by variable interest rates. Furthermore, there is no indication of a deceleration in non-amortising loans in the production of new credit. Both these loan characteristics exacerbate households' vulnerabilities and hamper their capacity to withstand a negative shock.

2.3 Vulnerabilities in the banking sector

Banks are the financial institutions most exposed to risks in the housing market in the Netherlands and stress tests run by De Nederlandsche Bank show that, in an adverse scenario, their expected mortgage loan losses could surge. A large proportion of banks' assets are Dutch-originated mortgage loans (23%). Stress tests show that a combination of higher default rates and lower collateral values would put them under strain. Furthermore, in the event of downward correction in house prices, Dutch banks would additionally suffer from the Dutch economy's high sensitivity to developments in the RRE market.

New mortgage lending has substantially increased in recent years, with the LTV ratio of new loans remaining very high. Roughly two-thirds of new loans to first-time buyers have an LTV ratio at or above 90%, and almost 40% have an LTV ratio of 100% or more. Moreover, LTI ratios of new loans have gradually increased over the past three years, and the share of new loans with LTI ratios close to the regulatory limit has increased over the past few years.

The vulnerability of banks has also been amplified by a loosening of mortgage lending standards in the past few years. Since the first quarter of 2017, the percentage of the banks reporting an easing in lending standards to loans to households for house purchases has increased considerably relative to the percentage of banks reporting a tightening. Furthermore, as previously outlined, LTV ratios of loans to first-time buyers in particular are exceptionally high from an international perspective. If these developments are combined with the signs of overvaluation in the housing markets, it appears that an adverse scenario, characterised by a correction in house prices and higher probability of borrowers defaulting, is not implausible.

The vulnerabilities posed by the developments mentioned above have not been reflected in the evolution of risk weight for mortgage loans at IRB banks, which are among the lowest in the EU. The exposure of Dutch IRB banks to domestic mortgage loans is around €528 billion, and it represents more than 95% of all the Dutch banking sector's exposures to domestic mortgage loans. IRB banks' average risk weight for domestic mortgage loans decreased from 13.22% in the first quarter of 2014 to 9.65% in the third quarter of 2019. To compare, for banks that follow the standardised approach, the average risk weight for domestic mortgage loans was 38% in the third quarter of 2019 – more than four times higher than that of IRB banks.

Section 3: Effectiveness and efficiency of the measure

3.1 How the measure addresses the identified risk

The proposed measure primarily aims to enhance Dutch banks' resilience to a potential severe downturn in the housing market. Dutch banks are highly exposed to the Dutch mortgage market, as 23% of their assets, on average, are Dutch mortgage loans. Risk weights currently assigned to Dutch mortgage loans are among the lowest in the EU. At the same time, De Nederlandsche Bank sees high and persistently increasing systemic risk in the housing market with sustained price increases in real estate in recent years. Therefore, from a macroprudential perspective, risk weights assigned to Dutch mortgage loans are deemed low in the light of increasing vulnerabilities. The ESRB also argued this in its recommendation.

Dutch banks are highly exposed to high LTV loans, which are more risky from a systemic perspective and also in terms of higher credit risk. High LTV loans are more likely to have negative equity following a bust in the housing market, which in the past has induced households to reduce consumption, prolonging the housing market bust. As a result, the impact of a housing market correction is expected to be larger when the share of high LTV loans is larger. The proposed measure reflects this negative externality, as the additional capital to be held for mortgage exposures will increase with the share of high LTV loans. In addition, as the measure will impose a higher floor on banks with a higher share of high LTV loans, it disincentivises banks from granting new high LTV loans.

The design of the measure is intended to be risk sensitive, in the sense that the floor increases with the LTV ratio of the underlying mortgage loans. The exposure to high LTV loans is a major concern but, in the Netherlands, the macroprudential authority does not have legally binding powers to reduce the LTV limit through borrower-based measures. The specific way in which the mapping between LTV and risk weights is done is motivated by several considerations: (i) that it leads to a substantial difference between risk weights of high and low LTV loans, which strengthens the risk-sensitivity of the measure; (ii) that risk weights increase gradually with the LTV ratio, preventing potential distortions through cliff effects; (iii) that by using a constant risk weight for part of the loan (up to 55% LTV), mapping also ensures that risk weights for low LTV loans are not too low from a macroprudential perspective.

De Nederlandsche Bank considers a floor that is dependent on the LTV ratio to be a better option than using a fixed add-on. The imposition of a fixed add-on could potentially lead to distorting effects as a result of reducing the incentive for IRB banks to estimate conservative parameters. On the contrary, imposing a floor that is dependent on the LTV ratio means that the capital impact of the measure is larger for more risky (higher LTV) loan portfolios, which could reduce the attractiveness of these loans for IRB banks. Nevertheless, it should also be noted that using an LTV ratio that is updated on a quarterly basis might imply some kind of procyclicality. This is because rising (declining) housing prices might induce lower (higher) LTVs and therefore lower (higher) risk weights. De Nederlandsche Bank has considered this effect when calibrating the measure. It will monitor the impact on the effectiveness of the measure and adjust the calibration of the measure if needed.

The calibration of the measure is intended to increase the average risk weights of IRB banks by 3-4 percentage points (from 11% to between 14% and 15%), raising the total amount of capital which IRB banks have to hold by €3 billion. De Nederlandsche Bank ran a top-down stress test, using the adverse scenario from the 2018 European Banking Authority (EBA) EU-wide stress test¹³, but also explicitly taking into account observed losses at the national level, while also ensuring that the results for individual banks were consistent at the macro level. This top-down stress test found that the average risk weight for mortgage loans could increase by as much as 8-11 percentage points in an adverse scenario. Given that the results from the top down stress test are substantially larger than the results of the EBA stress test in 2018 (which have already been used as input to the SREP), this implies that current capital requirements, including Pillar 2 Guidance (P2G), do not yet fully reflect the systemic risk. Therefore, the additional macroprudential requirements on top of the Pillar 2 requirements are justified. In a second analysis, De Nederlandsche Bank projected potential credit losses in a stress scenario for the housing market.¹⁴ De Nederlandsche Bank found that banks would incur sizeable losses on their mortgage portfolios, and that they would need to increase their capital by around €3 billion over a three year period to maintain their current capital levels.

While not leading to an immediate capital shortfall, the proposed measure would result in increased resilience. The estimated increase of around €3 billion in the total amount of required capital is already covered by the banks' voluntary buffers and therefore it is not expected to lead to an immediate capital shortfall. However, this would decrease banks' voluntary buffers and in the medium term it can be expected that banks would aim to maintain or restore their voluntary buffers for management purposes.

The introduction of a floor on risk weights will also help to ensure that macroprudential buffers remain effective. Capital buffers, such as the SyRB, the O-SII buffer and the countercyclical capital buffer, use risk-weighted assets as a base. If risk weights were to decline further, these buffers would become less effective. The same considerations apply to all capital requirements that are calculated in terms of risk-weighted assets, while the leverage ratio requirement serves as a non-risk-weighted backstop.

¹³ In the 2018 EBA scenario, Dutch house prices were around 25% lower after three years compared with the baseline scenario.

¹⁴ De Nederlandsche Bank performed a sensitivity analysis where probability of defaults (PDs) and loss given defaults (LGDs) increase over a three year period in line with the maximum increases that were observed during the previous housing market correction.

3.2 How the measure relates to possible alternatives

a) Article 124 of the CRR (risk weights in standardised approach)

According to 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, ranging from 35% to 150%, for exposures secured by mortgages on residential immovable property. They can also apply stricter criteria for the application of a 35% risk weight.

Article 124 of the CRR would not be effective in addressing the systemic risk identified, given that banks applying the standardised approach account for only a small fraction (around 5%) of mortgage lending by banks in the Netherlands. Moreover, the average risk weights of banks using the standardised approach are considerably higher than those of IRB banks, and are considered sufficiently high by De Nederlandsche Bank in relation to systemic risk.

b) Article 164 of the CRR (higher loss given default minimum)

According to Article 164 of the CRR, competent authorities can set higher minimum values of exposure-weighted average loss given default (LGD) for exposures secured by property, on the basis of financial stability considerations. The exposure-weighted average LGD for all the retail exposures that are secured by residential property and do not benefit from central government guarantees must not be lower than 10%. LGD is only one of the parameters used in the risk-weight function.

The ESRB is of the view that, given the narrower focus of Article 164 which only targets LGD, such a measure would not sufficiently address the intended purpose of the draft measure and could even have unintended results. Increasing the LGD would affect mainly loans with lower LGD but these are typically the ones that have lower LTV and therefore should potentially have lower risk. Also, assuming internal models are correctly calibrated, these would penalise more conservative banks. Furthermore, acting through the LGD would also affect other microprudential parameters, such as the calculation of expected loss amounts under Articles 158 and 159 of Regulation (EU) No 575/2013, which is not the intended purpose of the measure.

c) Article 101 of CRD IV (ongoing review of permission to use internal models)

Article 101 of the CRD establishes requirements for competent authorities to review permissions to use internal models. The competent authority shall review on a regular basis, and at least every three years, institutions' compliance with the requirements regarding approaches that require permission by the competent authorities before using such approaches for the calculation of own fund requirements. For significant institutions, this review is performed by the European Central Bank (ECB), while the review for less significant institutions is performed by De Nederlandsche Bank.

De Nederlandsche Bank considers Article 101 of the CRD to be inadequate in addressing the systemic risk identified. Under the Targeted Review of Internal Models (TRIM), undertaken by the ECB in 2019, any

material deficiencies that were found in the IRB models of Dutch banks have been addressed. However, from a macroprudential perspective risk weights remain low in the light of the increased systemic risk.

The ESRB highlights that the aim of the proposed measure is intrinsically macroprudential. The measure aims to mitigate an increase in systemic risk related to developments in the housing market; it does not aim to correct issues on a microprudential level.

d) Articles 103 and 104 of CRD IV (supervisory measures)

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.

De Nederlandsche Bank considers that acting on the basis of these articles would not be equally as effective as the proposed measure in terms of transparency, signalling effect and scope.

A clear distinction between microprudential and macroprudential measures improves transparency and strengthens accountability. In this regard, the use of Pillar 2 requirements is less appropriate than the proposed measure, which is meant to address systemic risk.

Publishing Pillar 2 measures is not mandatory, whereas the proposed measure has been publicly announced and is subject to a public consultation. Therefore, De Nederlandsche Bank sees more benefits in the proposed measure, in comparison with Pillar 2 requirements, in terms of a signalling effect, enhancing public transparency and allowing for more effective communication with market participants.

A Pillar 2 capital requirement would only consider the outstanding stock in the calibration of the requirement. This is because the Pillar 2 capital requirement is set in conjunction with the annual SREP. The proposed measure, which applies to stock and flow, provides a stronger disincentive to the provision of new high LTV loans compared to a Pillar 2 requirement.

e) Article 105 of CRD IV (liquidity requirements)

Article 105 of CRD IV regards specific liquidity requirements. The systemic risk that the proposed measure aims to address is not linked to banks' liquidity risk but to banks exposures to RRE risk.

f) Article 133 of CRD IV (systemic risk buffer)

Under 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.

Currently, a SyRB is already imposed on three systemically important institutions in the Netherlands. However, it does not target the main source of the increase in systemic risk currently identified – namely the housing market, which the proposed measure does target. Moreover, as De Nederlandsche Bank highlights, the

risk sensitive approach of the proposed measure (linked to LTV ratios) would currently not be possible using the SyRB.

g) Article 136 of CRD IV (countercyclical capital buffer)

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 a requirement applicable to domestic exposures. Currently, De Nederlandsche Bank does not see clear signs of overall excessive credit growth in the Netherlands, and credit growth to the non-financial private sector is even negative.

The CCyB is not an appropriate tool for addressing systemic risk linked to a subset of exposures and is not applicable 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, such as mortgage loans. Moreover, the CCyB would apply to all institutions, whereas the proposed measure targets only IRB credit institutions.

h) Using other measures

Using a tight LTV limit would seem to be an alternative and more straightforward way to address the risk of Dutch banks' exposures to high LTV loans. The Netherlands already has an LTV limit, which has gradually reduced from 106% in 2012 to 100% in 2018. The ESRB considers it to still be excessively high in absolute terms, in relation to the degree of overvaluation and when compared internationally.

The powers to impose a tighter LTV limit are not in the hands of De Nederlandsche Bank. Despite a recommendation from the Dutch Financial Stability Committee, the Dutch Government, as holder of the legally binding powers to implement such measures, has so far not initiated any measures to lower the LTV limit further.

Additionally, even if these measures were implemented, they would only apply to new loans and thus solely affect the flow, and not the stock, of the RRE portfolio. Therefore, these measures would still not address the underestimation of risks that can result from low risk weights in the stock of RRE exposures.

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 Dutch banking system, and thus to potentially enhance the overall resilience of the economy as a whole. The Dutch economy has a high sensitivity to house price shocks, with banks and households especially vulnerable to a downward correction in the housing market. Banks would be particularly affected not only because of their direct exposure to mortgages but also through indirect effects stemming from the high indebtedness of Dutch households, which makes them vulnerable to a downward correction in the housing market. If prices drop, high LTV mortgage loans would end up

having values exceeding the underlying loans. Homeowners with total debt exceeding the value of their home tend to consume less, as was observed during the last crisis.¹⁵

The resilience of Dutch banks to a potential house price correction is crucial to financial stability.

Generally speaking, banks are the most systemically important financial institutions. Moreover, of all financial institutions, banks are the most exposed to risks in the housing market. A large proportion of their assets are Dutch-originated mortgage loans: mortgage loans represent 23% of banks' portfolios, while for insurance firms this share is 14% and for pension funds only 3%. De Nederlandsche Bank estimates the proposed measure to increase the average risk weight of IRB banks' mortgage portfolios from 11% to between 14% and 15%, which would translate into an increase in the total amount of required capital by € 3 billion (of which more than € 2 billion is CET1 capital).

Stress tests show that banks' expected mortgage loan losses could surge in an adverse scenario.

This could be the case if the probability of default were to increase, for instance due to a sharp rise in unemployment, while collateral values were to simultaneously decrease due to a house price correction. Top-down stress test analyses from De Nederlandsche Bank show that risk weights could increase by as much as 8-11 percentage points in an adverse scenario that was also used in the EU-wide stress test conducted by the EBA in 2018. In this scenario Dutch house prices were around 25% lower after three years compared with the baseline scenario. The increased risk weights would depress the banks' CET1 capital ratios by 1 to 1.3 percentage points on average, which might erode confidence among market participants, particularly in times of crisis. As in the most recent crisis, market participants might be less willing to provide funding to Dutch banks, particularly given the latter's relatively low leverage ratios, which average 5.0%. Furthermore, Dutch banks still depend relatively heavily on market funding, which also contributes to their vulnerability to a house price correction.

The targeted nature and risk-sensitivity of the measure is aimed at avoiding spill-overs to overall credit extension and the real economy, contributing to its proportionality.

Because RRE is one of the main (domestic) sources of systemic risk in the Netherlands, the measure targets exposures secured by RRE. The measure affects banks only, for whom resilience to the indirect effect of a housing bust is likely to be more of a concern than for insurers and pension funds. De Nederlandsche Bank expects the impact of the proposed measure on credit provision to be limited. The measure aims to strengthen banks' resilience and is not meant to influence house price developments.

4.2 Cross-border effects and the impact on the Internal Market

De Nederlandsche Bank does not expect the measure to have a significant, negative impact on the EU Internal Market. The role of EU foreign lenders on the Dutch mortgage market is currently small. Domestic financial institutions are likely to remain dominant after this measure has been implemented. Nevertheless, De

¹⁵ A recent analysis from CPB Netherlands Bureau for Economic Policy Analysis shows that households whose mortgage loan was underwater or ended up underwater during the crisis, consumed 17% less of their average disposable income in 2014 than in 2007. Had they not moderated their consumption, nation-wide consumption would have been four percentage points higher in 2014.

Nederlandsche Bank intends to apply for voluntary reciprocity by the designated authorities of other Member States. Such reciprocity is not object of this opinion and will be dealt with separately.

Risk weights of Dutch banks are expected to remain relatively low compared to other Member States.

Even though the measure substantially increases the risk weights for mortgage loans of Dutch IRB banks, they are expected to remain relatively low compared to other Member States. Therefore, outward spillovers to other Member States are expected to be limited.

Contagion risk to other Member States is expected to be mitigated by increasing the resilience of the Dutch banking sector.

The Dutch financial sector is highly interconnected with the European, and the global, financial systems and thus this measure is expected to reduce potential contagion to other Member States by strengthening the resilience of the Dutch banking sector.

4.3 Domestic cross-sector effects and regulatory arbitrage

Banks have limited possibility of reducing the impact of the draft measure through model optimisation.

This is the case because the calibration does not depend on model outcomes, rather it depends on the LTV ratio of the underlying mortgage loans. The incentive for risk shifting is also limited as risk weight will increase as the LTV ratio increases.

The scope for regulatory arbitrage is limited, as the room to increase mortgage exposure of non-banks is not large.

Banks account for roughly two-thirds of new mortgage loans in the Netherlands, whereas the remaining market share is made up of insurance firms, pension funds and investment funds. This composition has remained broadly stable since 2016, following sharp growth in the mortgage exposures of non-banks up to that year. Following the implementation of the measure, the funding costs of banks might increase slightly and could in turn be passed on to borrowers by banks via increased lending rates. In principle, this could lead to an increase in the market share of non-banks. However, according to De Nederlandsche Bank, the room for non-banks, especially for insurers, to increase mortgage exposures is limited. There is also limited scope for intra-group transfers of loans for the bank-assurance sector in the Netherlands, as they are made of large insurers and relatively small banks that use the standardised approach.

Conclusions

The proposed measure primarily aims at enhancing the resilience of Dutch banks to a potential (severe) downturn in the housing market against the background of sustained price increases in real estate over the past years. Dutch banks are highly exposed to the Dutch mortgage market, and De Nederlandsche Bank finds that current risk weights assigned to Dutch mortgage loans, which are among the lowest in the EU, do not accurately reflect the high and persistently increasing systemic risk in the housing market. Also the ESRB, in its Recommendation to the Netherlands issued in June 2019, notes that since 2016 house prices have continued to increase, leading to pockets of overvaluation in major cities. Against this background, the LTV ratios of new mortgage loans have remained high, in particular because the regulatory limit of 100% that applies to LTV ratios does not require additional collateral for an event of a decrease in house prices. Moreover, the vulnerabilities posed by these developments, with regard to financial stability, have not been reflected in the application of risk weights for mortgage loans in the Netherlands, which are among the lowest in the EU. The ESRB is therefore of the view that the proposed measure will contribute to increase the resilience of Dutch banks to a possible materialisation of systemic risk in the real estate market.

Dutch banks are heavily exposed to high LTV loans, which pose significant systemic credit risk. High LTV loans are more likely to have negative equity following a contraction in the housing market, which in the past has induced households to reduce consumption, and has prolonged the housing market contraction. As a result, the impact of a housing market correction is expected to be larger if the share of high LTV loans is larger. The proposed measure reflects this negative externality, as the additional capital to be held for mortgage exposures will increase with the share of high LTV loans. In addition, as the measure will impose a higher floor on banks with more high LTV loans, it gives individual banks a disincentive to grant new high LTV loans.

The calibration of the measure is intended to increase the average risk weights of IRB banks by 3-4 percentage points (from 11% to between 14% and 15%) resulting in a €3 billion increase in the total amount of required capital. This amount of capital is already covered by the banks' voluntary buffers and therefore it is not expected to lead to an immediate capital shortfall. However, it would lead to a decrease in banks' voluntary buffers and, in the medium term, it is expected that banks will aim to maintain or restore their voluntary buffers for management purposes.

The introduction of a floor on risk weights will also help to ensure that macroprudential buffers remain effective. Capital buffers such as the SyRB, the O-SII buffer and the CCyB use risk-weighted assets as a base. If risk weights were to decline further, these buffers would become less effective. 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 highlights that the aim of the proposed measure is to mitigate an increase in systemic risk relating to developments in the housing market. Microprudential supervision can contain, but not completely remove, concerns about low risk weights during a macroeconomic expansion. The aim of microprudential supervision regarding internal models is to ensure compliance with regulatory requirements and the reduction of inconsistencies and unwarranted variability of risk weights across institutions, rather than to target specific

(minimum) levels of risk weights required for macroprudential reasons.¹⁶ The ESRB highlights the importance of harmonised supervision of internal models at the European level, also in view of the dispersion of risk weights across EU regions and countries.

Given that all macroprudential buffers are based on risk-weighted assets, it is essential that risk weights also reflect the systemic risk profile of underlying assets. Even if modelling practices of banks across the EU are compliant with regulatory requirements, they do not necessarily fully incorporate the systemic nature of risks as identified through macroprudential analysis. This is why it is important that national macroprudential authorities can act in a pre-emptive way when they identify a change in the intensity of macroprudential risk that is not reflected in the level of risk weights. The tailored macroprudential response provided by Article 458 of the CRR is therefore an essential tool in this respect.

The ESRB is of the view that the vulnerabilities stemming from the RRE market, and notably those of a systemic nature, have not been fully reflected in the application of risk weights for mortgage loans in the Netherlands. Therefore, the proposed measure, which imposes a floor on risk weights linked to LTV ratios, contributes to increase the resilience of Dutch banks to a possible materialisation of systemic risk in the real estate market. The ESRB is of the view that the measure should be supported.

¹⁶ Regulatory developments such as the EBA Guidelines on PD, LGD and defaulted assets, and supervisory checks of banks' compliance with regulation, including ECB Banking Supervision's TRIM, should help to reduce some concerns.