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ESRB
European Systemic Risk Board
European System of Financial Supervision

Assessment of the Belgian notification in accordance with Article 458 of Regulation (EU) No 575/2013 concerning the extension of a stricter national measure for residential mortgage lending

Introduction

On 27 January 2020, Nationale Bank van België/Banque Nationale de Belgique (NBB/BNB) notified the European Systemic Risk Board (ESRB) of its intention to extend the period of application of its current macroprudential measure based on Article 458(2)(d)(vi) of the Capital Requirements Regulation (CRR)[1]. The measure consists of the imposition of a macroprudential risk weight add-on on all domestic credit institutions applying the internal ratings-based (IRB) approach whose retail exposures are secured by residential immovable property for which the collateral is located in Belgium. The macroprudential add-on consists of two components. The first component imposes a 5 percentage point risk weight add-on for IRB banks' exposures to Belgian mortgage loans. The second, more targeted, component further increases the risk weights in function of the risk profile of the IRB banks' mortgage portfolio, by applying a multiplier of 1.33 to the microprudential risk weight of the residential mortgage loan portfolio. This measure was activated on 1 May 2018 and, in line with Article 458 of the CRR, remains active for two years, until 30 April 2020.

Pursuant to Article 458(4) of the CRR, the ESRB must provide the Council, the European Commission and Belgium 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/2015/4[2].

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)[3] 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?

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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 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. 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?

The ESRB's assessment draws on the information provided by NBB/BNB, 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 measure which is proposed to be extended consists of the imposition of a macroprudential risk weight add-on on all domestic IRB credit institutions whose retail exposures are secured by residential immovable property for which the collateral is located in Belgium. The macroprudential add-on consists of two components. The first component imposes a 5 percentage point risk weight add-on for IRB banks' exposures to Belgian mortgage loans. The second, more targeted component further increases the risk weights in function of the risk profile of the IRB banks' mortgage portfolio, by applying a multiplier of 1.33 to the microprudential risk weight of the residential mortgage loan portfolio.

The measure applies to retail exposures of IRB credit institutions secured by residential immovable property for which the collateral is located in Belgium. The measure focuses on IRB banks as their model-implied risk weights are relatively low compared with those implied by the standardised approach. The IRB banks in scope cover approximately 94% of the Belgian mortgage market. Both non-defaulted and defaulted exposures are targeted.

The extension of the measure is intended to apply from May 2020, the date the measure currently in force expires. NBB/BNB will announce the extension of the current measure in a press release on its website. This decision, including an NBB/BNB regulation and the enacting Royal Decree will be published in April 2020. As it concerns an extension of a measure already in force, no phasing-in stage is planned – the current measure will continue to be fully applicable to the Belgian residential mortgage loan portfolios held by all Belgian IRB banks.

The measure is extended for a period of one year, until 30 April 2021. NBB/BNB intends to review the calibration and appropriateness of the measure in December 2020. NBB/BNB will reassess the need for the current Article 458 CRR measure once CRD V/CRR II amendments enter into force in 2021**.** In this assessment, different alternatives will be considered — including the extension/deactivation of the Article 458 measure and/or activation of the sectoral systemic risk buffer (SyRB) — and evaluated in function of the developments in the level and distribution of stock risks in IRB banks' mortgage portfolios.

NBB/BNB intends to request the extension of the measure to be reciprocated by other Member States, under Article 458(8) of the CRR, once the extension of the measure has been enacted and implemented.

This request will be targeted at other Member States whose banking sector may be or may become exposed directly or indirectly through branches to the risks related to the residential real estate market in Belgium.

Article 458(10) of the CRR does not apply to the extension measure as the increase in average risk weights is expected to be higher than 25%. According to the calculations of NBB/BNB, the proposed measure is expected to increase targeted banks' average risk weight by more than 25%.

1.2 Background to the measure

The proposed extension of the measure primarily aims to ensure the resilience of Belgian IRB banks against residential real estate (RRE) risks. NBB/BNB has decided that an extension of the period of application of this measure by one year is required because the systemic risks identified when the measure was first introduced persist and bank exposures to the Belgian RRE market have further increased since 2018. This extension is necessary to maintain the resilience of the banking sector and ensure sufficient loss-absorbing capacity from a macroprudential perspective, commensurate with IRB banks' exposure to the Belgian RRE sector.

The ESRB in September 2019 issued a Recommendation to the Belgian authorities to take further measures aimed at mitigating risks in the housing market.[4] The purpose of this Recommendation was to recommend the activation of legally binding borrower-based measures in order to complement the existing macroprudential measures. By focusing on measures that address risks arising from new loans, the Recommendation also acknowledged that the current measure was still necessary to address the prevailing risks related to the stock of mortgage loans.

The extension of this measure is an integral part of a consistent set of complementary macroprudential instruments activated in Belgium. The countercyclical capital buffer (CCyB), which was activated on the back of increasing growth of credit to non-financial corporations, was activated in July 2019, at 0.5%, and will become binding from July 2020. Its main objective was to increase the resilience of the banks against Belgian cyclical risks and to absorb possible spillovers from RRE risks to the non-financial sector or address specific second-round effects. In addition, other more targeted measures are applied to RRE sector exposures. The current risk weight measure increases the resilience of banks to real estate exposures — covering the existing stock risks already on banks' balance sheets — and ensures that banks do not excessively rebalance towards the RRE market due to its lower risk weights, which would be a concern given the systemic cyclical risk of that sector. Moreover, the recently introduced supervisory expectations regarding sound credit standards in mortgage lending

[4] See **Recommendation of the European Systemic Risk Board of 27 June 2019 on medium-term vulnerabilities in the residential real estate sector in Belgium (ESRB/2019/4).**

may, in the medium term, improve credit quality and hence limit any additional build-up of credit risk in future mortgage portfolios.

Section 2: Analysis of the underlying systemic risks

In recent years, the ESRB has been monitoring risks related to the RRE sector in Belgium as well as in all other EU Member States.[5] These assessments 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 and recommendations that were issued in 2016 and 2019 to several countries.

Medium-term vulnerabilities in the RRE sector in Belgium have led the ESRB to issue in 2016 a Warning[6] **and in 2019 a Recommendation**[7] **to Belgium.** In 2016, the main vulnerabilities in the RRE market in Belgium mainly concerned the rapid growth in both house prices and mortgage loans, as well as the already high and increasing household indebtedness, with an increasing share of mortgagors being potentially vulnerable to adverse economic conditions or developments in the RRE market in Belgium. The new assessment, concluded in June 2019, revealed that since 2016 in Belgium: (i) house price growth had decelerated but the previous dynamics still raised concerns about potential overvaluation, (ii) strong growth in housing credit had continued to fuel household indebtedness, and (iii) a significant share of mortgage loans had continued to be provided to households that are potentially vulnerable to adverse economic or financial conditions or adverse developments in the RRE market.[8]

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

Since 2000, property prices for RRE in Belgium have increased substantially in both nominal (+150%) and real terms (+77%). In contrast to most Member States, in Belgium the financial crisis did not trigger a major downward correction of nominal prices in the RRE market. In fact, prices continued to rise fast in the decade after

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5 For more details see "**Vulnerabilities in the EU residential real estate sector", ESRB, November 2016** and "**Vulnerabilities in the residential real estate sectors of the EEA countries",** ESRB, September 2019.

6 See **Recommendation of the European Systemic Risk Board of 27 June 2019 on medium-term vulnerabilities in the residential real estate sector in Belgium (ESRB/2019/4).**

7 See **Warning of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of Belgium (ESRB/2016/6).**

8 For more details see "**Vulnerabilities in the residential real estate sectors of the EEA countries**", ESRB, September 2019, pages 76-78.

the global slowdown. The reference price index for RRE has kept growing in recent years and currently stands at the highest level recorded. In Q3 2019 the yearly growth rate of house prices was 3.6%, in line with the figures for 2017 and 2018, which were 3.8% and 3.6%, respectively. Since 2000, general consumer price indices have lagged behind nominal house prices, causing the real price of residential real estate to rise by 77%. In real terms, prices grew by 2.6% in Q3 2019 (annualised) and by 1.8% in 2018.

Fundamentals do not seem to justify this prolonged surge in RRE prices and many of the benchmark valuation measures point to a persistent overvaluation in the Belgian RRE market. NBB/BNB uses a model-based time series approach to explain real house price developments based on a number of key determinants, including interest rates, real disposable income, characteristics of mortgage loans, the tax regime applicable to residential property, and demographic developments. According to NBB/BNB valuations, in Q3 2019 Belgian RRE prices were overvalued by 7.3%. In Q2 2018 NBB/BNB reported an overvaluation of 5.9% while the International Monetary Fund estimated it at 8% and the European Central Bank (ECB) at 15% for the same period.

Changes to the current level of fundamentals or unexpected severe shocks to these variables could result in substantial downward price corrections towards new equilibriums. In addition to the uncertainty that is intrinsic in any model, these overvaluation estimations are highly dependent on the current level of fundamentals. For instance, future increases in the level of interest rates could push the equilibrium price of the Belgian RRE market to a much lower point. Similarly, abrupt changes in climate change policy could have a significant impact on the value of old and unrenovated residential properties, which account for a large portion of the overall market.[9] Further, there is the risk of more severe price corrections than the models predict as negative feedback loops could trigger overshooting of the equilibrium price. Finally, according to NBB/BNB, the recent withdrawal of real estate tax benefits has not been incorporated yet and is expected to weigh on prices in the medium term.

2.2 Vulnerabilities in the household sector

Belgium has recorded some of the strongest increases in household indebtedness since the financial crisis in euro area comparison. Household debt vis-à-vis GDP has been steadily increasing and reached 61.1% in Q3 2019 (up from 55.3% in 2012). Compared with other euro area countries, Belgium has recorded some of the strongest increases in household indebtedness since the financial crisis and its debt ratio now exceeds the euro area average. According to NBB/BNB, this difference is projected to widen further in the coming years. Growth in mortgage lending has averaged around 5.5% per annum from the end of 2014 to November 2019, well above the euro area average of 2.6% for the same period.

[9] For more details see Bourtembourg, J., Dumont, L., Francart, A., and Van Tendeloo, B, "**Climate-related risks and sustainable finance**", *Financial Stability Report*, Nationale Bank van België/Banque Nationale de Belgique, Brussels, 3 June 2019, pp. 107-127.

Belgian households have been experiencing looser lending standards set by mortgage lenders. New loans have been increasingly granted with higher loan-to-value (LTV) ratios, debt service-to-income (DSTI) ratios and extended maturities. The share of new loans carrying an LTV greater than 90% has gradually expanded in recent years, from 28% in 2014 to 35% in the first half of 2019. Notwithstanding further reductions in interest rates in the same period of time, the share of new mortgage loans with DSTI ratios above 50% remains high at 21.5%. Furthermore, banks have recently started to extend the maturity of mortgage loans. Loans with maturity between 20 and 25 years now account for 39% of total loans, compared with 29% in 2016. The increase in riskiness of loans originated in recent years means that there has been no reduction in the relative share of the "riskier loan segments". Average index-linked LTV figures indicate that 14% (i.e. €29 billion) of the total outstanding stock carries an indexed LTV above 90%.[10]

These developments may indicate the presence of risk pockets of overindebted households, which may be more vulnerable in case of a crisis. In the event of a financial shock, household vulnerabilities could lead to defaults in loans or adjustments in consumption to meet the loan repayments. In any case, these could have second-round effects. This is why NBB/BNB is of the view that the current proportion of loans in the riskier segments remains too high and that as credit standards continue to deteriorate, this could contribute to future stock risks in banks' portfolios.

2.3 Vulnerabilities in the banking sector

The Belgian banking sector continues to expand its exposure to the RRE sector. Total outstanding mortgage loans granted by Belgian banks to Belgian households grew from €169 billion at the end of 2014 to €212 billion in November 2019, which corresponds to an increase from 15% to about 20% of banks' total assets. Banks' business plans also indicate that sustained new mortgage lending can be expected in the coming years. Against the backdrop of continued low interest rates, this has intensified competition and increased risk-taking.

Intense competition between credit institutions on the mortgage loan market might lead to increased risk-taking. Based on an analysis of banks' business plans, banks expect sustained new mortgage lending in the coming years. In view of the low interest rate environment, which puts pressure on banks to mitigate its impact on profitability, a widespread strategy of stepping up mortgage lending may induce intense competition between the main credit institutions. Strong competition could support greater risk-taking.

The vulnerabilities of banks are amplified by a general loosening of credit standards, as the share of the riskier exposures in banks' mortgage portfolios continues to be high. In recent years the share of newly

[10] However, there are also a number of mitigating factors. These include, in particular: (i) the high share of loans with a fixed interest rate; (ii) legal limits on the interest rate variability of mortgage loans; (iii) the fact that mortgage loans are generally amortising, with maturities of no more than 25 years at origination; and (iv) the high level of financial assets held by households relative to their debt.

originated loans with an LTV greater than 90% has risen and the share of new loans with a DSTI above 50% remained high. Moreover, the average maturity has increased while bank margins on mortgage loans have gone down, reflecting the continued intense competition in the market. There is also evidence of an increase in the number of loans taken out for acquiring a second property for buy-to-let purposes, which may be seen as a speculative investment.

The vulnerabilities posed by the developments mentioned above have not been reflected in the evolution of risk weights for mortgage loans in IRB banks. These risk weights are among the lowest in the EU. The average risk weight for mortgage loans calculated by internal models (i.e. before taking into account the macroprudential measures) is 9.8%, firmly in the lower end of EU distribution. This implies that a small amount of capital is put against these exposures relative to the systemic risks implied.

Section 3: Effectiveness and efficiency of the measure

3.1 How the measure addresses the identified risk

The measure which is proposed to be extended aims to enhance the resilience of Belgian IRB banks to potential severe downward corrections in RRE markets in Belgium. Against the background of intensifying credit exposures of Belgian households and banks as well as sustained price increases that raise overvaluation concerns, NBB/BNB considers that systemic risk in the RRE market in Belgium has been building up. Also, the ESRB assessment of medium-term vulnerabilities in the RRE sector in Belgium in 2019 concludes that: (i) price dynamics raise concerns about potential overvaluation, (ii) strong growth in housing credit continues to fuel household indebtedness, and (iii) a significant share of mortgage loans continue to be provided to households that are potentially vulnerable to adverse economic or financial conditions or adverse developments in the RRE market. In the same report, the ESRB also emphasises the suitability of existing capital-based measures to ensure sufficient capital for the stock risks in banks' RRE mortgage portfolios.[11]

The need for maintaining the measure arises from the low microprudential risk weights applied to real estate exposures by IRB banks against the background of substantial vulnerabilities at the macro level. Given the macro-financial nature of the vulnerabilities which were described in the previous section, the impact of a potential crisis at the macro level might not be accurately reflected in the internal models, especially since Belgium has not experienced any major real estate crisis in the recent past. Therefore, the estimation of risk weights under the IRB approach, which has a backward-looking perspective, cannot fully incorporate the potential

[11] See "**Vulnerabilities in the residential real estate sectors of the EEA countries**", ESRB, September 2019.

outcome of such a major crisis.[12] The vulnerabilities posed by the developments described in the previous section have not been reflected in the evolution of risk weights for mortgage loans in IRB banks.

The current measure remains necessary as a complement to the recent publication by NBB/BNB of supervisory expectations regarding mortgage credit standards. Issued in response to the ESRB Recommendation of September 2019, these new supervisory expectations target the flow of new mortgage loans, whereas the existing measure under Article 458 of the CRR is designed to ensure sufficient capital for the stock risks in banks' RRE mortgage portfolios. Furthermore, the ESRB considers that borrower-based measures, or measures targeting the flow of new loans (such as these supervisory expectations), are more effective when combined with measures targeting stock vulnerabilities, which is the aim of the current measure.

The design of the measure is intended to increase resilience while being risk-sensitive. The measure combines an add-on that affects all banks with a risk multiplier that aims to adjust the impact of the measure to the risk profile of the banks. NBB/BNB is of the view that the microprudential risk weight obtained from internal models reflects the risk profile and credit quality of borrowers.[13] For this reason, it believes that banks with lower risk weights contribute less to the overall build-up of systemic risk and should therefore be affected less by the implementation of the RRE measure. This is irrespective of the macroprudential concerns that justify the use of this measure, i.e. concerns that the current levels of risk weights do not reflect the evolution of all macro-financial risk and vulnerabilities that have been building up over the recent years.

The calibration of the measure is intended to increase the implied risk weights on mortgage exposures from approximately 9.8% to 18.1% on average. The calibration of the current measure was based on the severe (macroprudential) stress scenario in the original notification of 2018. In view of recent developments in the Belgian mortgage market, NBB/BNB deems this stress scenario to be meaningful and severe enough to be used to calibrate the measure. An update of the sensitivity/scenario analysis performed indicates that, on the one hand, microprudential capital requirements (implied by microprudential risk weights) remain insufficient to cover all potential (macroprudential) losses under severe (macroprudential) stress scenarios and, on the other hand, that the current macroprudential measure (with the original calibration) is sufficient to cover the simulated losses – at the sector level.

The total impact of the proposed measure on IRB banks' CET1 capital is estimated at €1,802 million, equivalent to approximately 3.4% of IRB banks' total CET1 capital. This compares with €1,486 million at the time of the original notification in 2018, which is commensurate with the higher RRE exposures of Belgian IRB

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[12] The ESRB acknowledges that EBA Guidelines on PD estimation, LGD estimation and treatment of defaulted exposures should help to reduce some, but not all concerns going forward. However, given that they will be applied from 31 December 2021, they are outside the extension period of the proposed measure.

[13] NBB/BNB found cross-sectional evidence of a strong correlation between the banks' risk weights and risk parameters, such as the probability of default and the share of risky loans (in terms of LTV, DSTI or maturity).

banks. A breakdown by the contribution of each of the two components of the measure implies a CET1 impact of €1,096 million (2.1% of total CET1 capital) due to the 5 percentage point risk weight add-on and an additional impact of €706 million (1.3% of total CET1 capital) from the second component. The measure pushes up the implied risk weights (on mortgage exposures) from approximately 9.8% to 18.1% on average, broken down into an increase of 5 percentage points for the first component (by construction) and 3.1 percentage points for the second component. The substantial increase in risk weights for residential real estate exposures implies that the total impact of €1,802 million in CET1 capital corresponds to an 84% increase in the capital buffer compared with the microprudential CET1 capital requirements for this portfolio.

The extension of the add-on to risk weights will also help to ensure that macroprudential buffers remain effective. Capital buffers use risk-weighted assets as a base. If risk weights do not correctly reflect the systemic risks, the buffers are 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. In Belgium, where a CCyB rate of 0.5% will be activated in July 2020, the impact on the CCyB of the increase in risk weights through this Article 458 measure will correspond to an additional capital requirement of around €50 million in CET1 capital for IRB banks.

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 6%) of mortgage lending by banks in Belgium. Moreover, the average risk weights of banks using the standardised approach are considerably higher than those of IRB banks.

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. Paragraph 4 of this article states that 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%. However, 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 potentially have unintended consequences. Assuming internal models are correctly calibrated, setting a higher LGD would penalise more conservative banks, while the capital add-on implied by this measure will also vary according to the risk profile of the portfolio. 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 the CRR, which is not the intended purpose of the measure.

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

Article 101 of the CRD IV 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 Belgian significant institutions, this review is performed by the ECB, while the review for less significant institutions is performed by NBB/BNB.

NBB/BNB considers Article 101 of the CRD IV to be inadequate for addressing the systemic risk identified. According to NBB/BNB, IRB banks comply with all the requirements to use internal models. The transversal review conducted by NBB/BNB in 2014 did not raise any general concerns about the adequacy of the internal models. The low risk weights implied by these models partly reflect the absence of a major crisis in Belgium in recent decades, which makes it harder to fully reflect the potential outcome of such crises. However, where individual and specific weaknesses were observed, banks concerned were required to review their internal models. A further in-depth horizontal review of banks' internal models by the ECB, the targeted review of internal models (TRIM), has not resulted in major changes in risk weights so far.

The ESRB also 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 and it does not aim to correct issues on a microprudential level.

d) Articles 103 and 104 of the CRD IV (supervisory powers)

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.

NBB/BNB considers that acting on the basis of these articles would not be as effective as the proposed measure, highlighting reasons of transparency and scope:

- Pillar 2 requirements are not communicated with detailed quantification according to type of risks. NBB/BNB emphasises the importance of the macroprudential measure's signalling function to the banks and the general public, especially in the context of the build-up of vulnerabilities (riskier loans) in Belgium.

- Pillar 2 requirements would also affect the capital requirements related to any new lending and exposures other than mortgage loans. The common practice of the supervisory authorities (NBB/BNB and the ECB) is to take a SREP (Pillar 2) decision once a year in the form of a general CET1 ratio requirement. In theory, it is possible to raise the required Pillar 2 CET1 ratio by an appropriate percentage, reflecting the amount of capital needed to cover the current measure on mortgage loans at the date of the decision. Nevertheless, this would also affect the capital requirements related to any new lending and exposures other than mortgage loans.

The ESRB considers that a clear distinction between microprudential and macroprudential measures improves transparency and strengthens accountability. The purpose of the measure is intrinsically macroprudential. It aims to mitigate an increase in systemic risks related to developments in the RRE market in Belgium – risks which are currently not fully reflected in the risk weights calculated through the internal models of IRB banks.

e) Article 105 of the CRD IV (liquidity requirements)

Article 105 of the CRD IV concerns 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 the CRD IV (systemic risk buffer)

Under Article 133 of the 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, the SyRB is not designed to apply to specific sectoral exposures. If the SyRB were to be used and applied to all exposures in Belgium, this would penalise all credit, including other exposures to SMEs and corporates in Belgium, which is not the desired outcome. Therefore, NBB/BNB considers that the SyRB, in its current form, is inadequate for addressing the specific risk in the RRE market as targeting only such exposures is not possible under Article 133 of the CRD IV. However, NBB/BNB intends to reassess the need for the current Article 458 measure when Directive (EU) 2019/878[14] becomes applicable and allows the application of a sectoral SyRB to retail exposures secured by residential property.

[14] Directive 2019/878/EU of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures (OJ L 150, 7.6.2019, p. 287).

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

The 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.

The CCyB is not an appropriate tool for addressing systemic risks 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 the CRR. 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.

Belgium has recently activated the CCyB at 0.5%, which will be binding from July 2020 onwards. This CCyB measure, however, targets the observed acceleration of the Belgian credit cycle (driven mainly by corporate credit) and does not specifically target risks in real estate markets.

h) Using other measures

In January 2020, NBB/BNB introduced supervisory expectations regarding sound credit standards in mortgage lending.[15] Issued in response to the ESRB Recommendation of September 2019, these new supervisory expectations target the flow of new mortgage loans, whereas the current Article 458 measure is designed to ensure sufficient capital for the stock risks in banks' RRE mortgage portfolios. Both measures are therefore complementary.

These supervisory expectations regarding sound credit standards in mortgage lending may, in the medium term, improve credit quality and so limit any additional build-up of credit risk in future mortgage portfolios. Nevertheless, the proposed measure is still necessary to address the vulnerabilities arising from the stock of loans already on the bank's balance sheet. As already mentioned by the ESRB in its September 2019 report, "borrower-based measures [i.e. supervisory expectations in this case] are more effective when combined with measures targeting the stock vulnerabilities", which is precisely the goal of extending the existing measure under Article 458 of the CRR.

[15] For more details see NBB/BNB website: **Press release**, **Circular** and **Annex to Circular.**

Section 4: Analysis of the net benefits of the measure

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

The proposed extension of the measure is expected to contribute to the resilience of the Belgian banking system, and thus to potentially enhance the resilience of the economy as a whole. Given the growing importance of residential mortgage loan portfolios on the balance sheet of Belgian credit institutions (around 20% of total assets and 401% of CET1 capital, on average), a severe downturn in the Belgian RRE market may have a substantial impact on Belgian credit institutions' solvency positions. 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 Belgian households. This would, in turn, bring about unfavourable consequences for the Belgian real economy. In fact, severe market corrections can also affect the real economy, even in the absence of any major rise in defaults. A decline in consumer confidence as a consequence of increased market volatility or negative wealth effects, for instance, or the prioritisation of solving a potential debt overhang problem, are likely to weigh on consumption and on the economy at large, with potential second-round effects in the form of increasing overall credit risks.

The targeted nature of the measure contributes to its proportionality by aiming to avoid spillovers to overall credit extension and the real economy. The measure targets only exposures secured by RRE. NBB/BNB has not seen any signs that the measure currently in place and proposed to be extended has had a strong impact on the overall credit supply (in terms of either pricing or volume) or, indirectly, on the real economy.

The risk sensitivity of the measure also contributes to its proportionality. The measure combines an add-on that affects all banks with a risk multiplier that aims to adjust the impact of the measure to the risk profile of the banks' portfolios. NBB/BNB assesses that the microprudential risk weight obtained from internal models reflects the risk profile and credit quality of borrowers.[16] For this reason, it believes that banks with lower risk weights contribute less to the overall build-up of systemic risk and should therefore be subjected to a lower requirement on their risk weight increase. This is irrespective of the macroprudential concerns that justify the use of this measure, i.e. concerns that the current levels of risk weights do not reflect the evolution of all macro-financial risk and vulnerabilities that have been building up over the recent years.

Macroprudential stress tests show that banks' expected mortgage loan losses could surge in an adverse scenario. The calibration of the current measure was based on the severe (macroprudential) stress scenario in the original notification of 2018. In view of recent developments in the Belgian mortgage market, NBB/BNB deems this stress scenario to be meaningful and severe enough to be used to calibrate the measure. An update of the

[16] NBB/BNB found cross-sectional evidence of a strong correlation between the banks' risk weights and risk parameters, such as probability of default, and the share of risky loans (in terms of LTV, DSTI or maturity).

sensitivity/scenario analysis performed indicates that, on the one hand, microprudential capital requirements (implied by microprudential risk weights) remain insufficient to cover all potential (macroprudential) losses under severe (macroprudential) stress scenarios and, on the other hand, that the current macroprudential measure (with the original calibration) is sufficient to cover the simulated losses – at the sector level.

The resilience of Belgian banks to adverse development in the Belgian RRE market is crucial to financial stability. Residential mortgage loan portfolios represent a significant share of banks' balance sheets (around 20% of total assets and 401% of CET1 capital, on average) and therefore it is important to ensure their resilience. The total impact of the proposed measure on IRB banks' CET1 capital is estimated at €1,802 million (compared with €1,486 million at the time of the original notification in 2018), equivalent to approximately 3.4% of IRB banks' total CET1 capital. The bigger impact of the measure on CET1 capital is commensurate with the higher RRE exposures of Belgian IRB banks.

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

NBB/BNB does not expect the measure to have a significant negative impact on the EU Internal Market. Since the implementation of the current measure, NBB/BNB has not observed any signs of negative impact on the Internal Market that would outweigh the financial stability benefits resulting in a reduction of the macroprudential or systemic risk identified. Neither does it expect this observation to change during the one-year period of extension of the measure. Furthermore, in view of the importance of cross-border banking groups in Belgium and the degree of openness of the economy, safeguarding financial stability in Belgium will also have positive effects on financial stability in Europe.

In view of the systemic nature of the identified risks and the international character of the Belgian banking sector, NBB/BNB intends to ask for voluntary reciprocation of the measure by designated authorities of other Member States. This request will be addressed to Members States whose banking sector may be (or become) exposed directly or indirectly (through their branches) to the risks related to the RRE market in Belgium. NBB/BNB will ask the ESRB to recommend reciprocation once the extension of the measure has been enacted and implemented. The request for reciprocation is not the subject of this opinion and will be dealt with separately.

4.3 Domestic cross-sector effects and regulatory arbitrage

NBB/BNB has not detected any substantial leakage to the non-bank sector from the current measure. The market share of non-banking institutions in the provision of new mortgage lending in Belgium has gradually decreased since the introduction of the current measure, from around 14% to 12%. Among the non-banking institutions, the market share of insurance companies in mortgage provision has remained relatively stable, around 2%. In terms of stock, NBB/BNB has not observed any major change after the introduction of the current measure. The total mortgage debt of insurance companies has only slightly increased and is approximately 6% of

total mortgage debt in Belgium. Nevertheless, NBB/BNB will continue to monitor developments that might imply regulatory arbitrage.

The ESRB highlights the importance of a continuous monitoring of developments in the non-banking sector. From a financial stability perspective it is important to ensure that stricter measures in one part of the financial system are not circumvented by the transfer of exposures to other financial intermediaries. Especially in countries such as Belgium, where the share of mortgage loans by non-banks is not irrelevant, a close monitoring of developments is paramount.

Conclusions

The ESRB supports NBB/BNB's intention to extend the period of application of its current macroprudential measure to increase risk weights for IRB banks' exposures to the Belgian RRE sector. The ESRB also supports the measure currently in place[17] and considers that recent developments in the RRE sector in Belgium warrant the extension of the measure.

The measure that is proposed to be extended aims at enhancing the resilience of Belgian IRB banks to potential severe downward corrections in RRE markets in Belgium. Against the background of intensifying credit exposures of Belgian households and banks as well as sustained price increases that raise overvaluation concerns, NBB/BNB considers that systemic risk in RRE market in Belgium has been building up. Furthermore, the ESRB assessment of medium-term vulnerabilities in the RRE sector in Belgium concluded in 2019 highlights that since 2016: (i) house price growth had decelerated but the previous dynamics still raised concerns about potential overvaluation, (ii) strong growth in housing credit had continued to fuel household indebtedness, and (iii) a significant share of mortgage loans continued to be provided to households that are potentially vulnerable to adverse economic/financial conditions or adverse developments in the RRE market. Following this assessment, the ESRB issued a Recommendation regarding the need to complement measures already in place with borrower-based measures to target risk arising from new loans. Thus, in its Assessment the ESRB assumed that the current measure was still necessary to address the prevailing risks related to the stock of mortgage loans.

The ESRB is of the view that the extension of the proposed measure is necessary to ensure the resilience of Belgian banks to systemic risk potentially materialising in the RRE market. The measure targets the stock risks in banks' RRE exposures arising from the persistence of systemic risks: overvaluation, increasing household leverage and low capital buffers. It is calibrated in a way that ensures sufficient capital buffers

[17] See **Opinion of the European Systemic Risk Board of 16 February 2018 regarding Belgian notification of a stricter national measure based on Article 458 of Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms** and attached **assessment note entitled "Assessment of the Belgian notification in accordance with Article 458 of Regulation (EU) No 575/2013 concerning the application of a stricter national measure for residential mortgage lending",** which is an integral part of this Opinion.

(securing resilience in the banking sector) to overcome a severe downturn scenario. Moreover, it is complementary to the recently published NBB/BNB supervisory expectations regarding sound credit standards in mortgage lending, which, in the medium term, improve credit quality, thereby limiting any additional build-up of credit risk in future mortgage portfolios.

The ESRB is of the view that the vulnerabilities stemming from the RRE market in Belgium, notably those of a systemic nature, are not fully reflected in the risk weights for mortgage loans derived from internal models. Belgium has not experienced any significant real estate crisis in the recent past. Therefore, the estimation of risk weights under internal model approaches, which have a backward-looking perspective, cannot fully incorporate the potential outcome of such future crisis. The ESRB acknowledges that the EBA Guidelines on PD estimation, LGD estimation and treatment of defaulted exposures could help to reduce some, but not all, concerns going forward.[18] However, given that these guidelines will apply from 31 December 2021, they are outside the extension period of the proposed measure.

The calibration of the measure is intended to increase the implied risk weights on mortgage exposures from approximately 9.8% to 18.1% on average. The calibration of the current measure was based on the severe (macroprudential) stress scenario in the original notification of 2018. The total impact of the proposed measure on IRB banks' CET1 capital is estimated at €1,802 million (compared with €1,486 million at the time of the original notification in 2018), equivalent to approximately 3.4% of IRB banks' total CET1 capital. The bigger impact of the measure on CET1 capital is commensurate with the higher RRE exposures of Belgian IRB banks.

The introduction of an add-on to risk weights will help to ensure that macroprudential buffers remain effective. Capital buffers use risk-weighted assets as a basis. If risk weights do not correctly reflect the systemic risks, the buffers 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. In Belgium, where a CCyB rate of 0.5% will be activated in July 2020, the impact on the CCyB of the increase in risk weights through this Article 458 measure will correspond to an additional capital requirement of around €50 million in CET1 capital for IRB banks.

The ESRB highlights that the aim of the measure and its extension is to mitigate an increase in systemic risk relating to developments in the RRE market. Microprudential supervision can alleviate, 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

[18] The current risk weight calculation based on the Basel formula does not necessarily account appropriately for the systemic risk dimension as the asset correlation parameter for mortgage loans is low relative to what could happen during a RRE crisis.

(minimum) levels of risk weights required for macroprudential reasons.[19] 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.

[19] 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 alleviate some concerns.