ESRB
European Systemic Risk Board
European System of Financial Supervision

Assessment of the Swedish 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 16 September 2020 Sweden's Finansinspektionen (FI) officially notified the European Systemic Risk Board (ESRB) in accordance with Article 458(2)(d)(vi) of the Capital Requirements Regulation (CRR) [1] of its intention to extend a national measure limiting risks stemming from Swedish mortgage loans. FI is the designated authority in charge of the application of Article 458 of the CRR in Sweden. [2] Pursuant to Article 458(4) of the CRR, the ESRB must provide the Council, the European Commission and Sweden with an opinion within one month of receiving the notification. The opinion must be accompanied by an assessment of the national measure in terms of the points mentioned under Article 458(2) of the CRR.

The ESRB's assessment focuses on the net benefits of the national measure for maintaining financial stability. The procedural framework for the provision of opinions under Article 458 of the CRR is clarified in Decision ESRB/2015/4[3]. 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 (the CRD IV)[4] and the CRR adequately address the risk, taking into account their relative effectiveness?
- **Effectiveness**: Is the measure likely to achieve its intended objective?
- **Efficiency and suitability**: Will the measure achieve its objective in a cost-efficient way, i.e. are the instrument and calibration appropriate?

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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] According to Chapter 1, Section 6, second paragraph of the Special Supervision of Credit Institutions Act (2014:968) Finansinspektionen 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).

- **Proportionality and impact on the internal market:** Is there an appropriate balance between the costs resulting from the measure and the problem it aims to address, taking into account any potential cross-border spillover effects? Where appropriate, the ESRB may suggest amendments to the measure to mitigate potential negative spillover effects.

The ESRB's assessment draws extensively on information provided by, and discussions with, FI and its staff. The ESRB has also relied on the assessment carried out prior to issuing its warning of 22 September 2016 and its recommendation of 27 June 2019.[5]

Section 1: Description and background of the measure

1.1 Description of the measure

The draft measure is an extension of the current measure under Article 458 of the CRR, which has been in place since 31 December 2018. It consists of a risk-weight floor of 25% for Swedish mortgage loans applied to credit institutions that use the internal ratings-based (IRB) approach. The draft measure targets domestically authorised credit institutions[6], or a subset of those institutions, and falls under Article 458(2)(d)(vi) of the CRR. The measure is intended to continue mitigating the changes in the intensity of risk and concerns risk weights for targeting asset bubbles in the residential and commercial real estate sector. The measure is an extension scheduled to enter into force on 31 December 2020 for a period of one year with possible renewal thereafter. Since the impact of the draft measure is, on average, more than 25% of the risk weights for those banks concerned which use the IRB approach, Article 458(10) of the CRR does not apply.

The mortgage loans targeted by the measure consist of retail exposures[7] to Swedish obligors collateralised by immovable property[8] (referred to in this assessment as "Swedish mortgage loans"). The exposure class largely consists of mortgages granted to private individuals, but can also include certain exposures to small businesses with loans collateralised by real estate. Additionally, it may include certain exposures collateralised by real estate other than residential property.

The draft measure applies to credit institutions that have authorisation to use the IRB approach ("IRB credit institutions") and have an exposure to Swedish mortgage loans. This includes subsidiaries based in

5 See Warning ESRB/2016/11 of 22 September 2016 and Recommendation ESRB/2019/9 of 27 June 2019 on medium-term vulnerabilities in the residential real estate sector of Sweden and the ESRB's report entitled "Vulnerabilities in the EU residential real estate sector", September 2019.

6 For the purpose of this assessment, the term "bank" has the same meaning as "credit institution" as defined under Article 4 of the CRR.

7 Article 147(2)(d) of the CRR.

8 Article 154(3) of the CRR.

Sweden of foreign credit institutions. FI aims to cover branches of foreign credit institutions and direct cross-border exposures of foreign banks by requesting reciprocation of the measure. Credit institutions using the standardised approach to calculate the capital requirement for credit risk are not affected. That requirement applies to the individual institutions and at the consolidated level.

The 25% floor applies to the exposure-weighted average risk weight for the portfolio of Swedish mortgage loans mentioned above. The exposure-weighted average risk weight is calculated by dividing the portfolio's risk-weighted exposure amount (as calculated in accordance with Articles 154 and 154(3) of the CRR) by the exposure at default amount (EAD).

FI requested reciprocation of the existing measures by other Member States under Article 458(8) of the CRR and the General Board of the ESRB decided to recommend reciprocation.[9] The ESRB's recommendation for reciprocation of the existing measure will continue to apply to the measure in its extended form. FI emphasised that reciprocity remains relevant in order to avoid leakages and regulatory arbitrage. It notably highlights that there is significant lending via branches from Danske Bank and Nordea, which exposes these banks to the risk related to the real estate market in Sweden.

1.2 Background of the measure

The proposed extension of the measure comes at a time of severe economic crisis, triggered by the impact of the coronavirus (COVID-19) pandemic. However, the exact duration and severity of the economic shock triggered by COVID-19 is still uncertain at the current juncture. Therefore, FI did not mention explicitly the consequences of the shock when notifying their extension of the measure. Nonetheless, it is already clear that the pandemic is having a profound negative impact on corporates across the globe. This will lead to an increased level of indebtedness at the global level and also for Swedish banks.

FI has been applying the measure under Article 458 of the CRR since 31 December 2018. Previously, a risk-weight floor for Swedish mortgage loans within the Pillar 2 framework had been applied since May 2013. The floor was introduced as part of the supervisory capital assessment under Pillar 2 to cover risks that are not fully captured by the regulatory capital requirements.

FI indicated that its primary motivation for continuing to apply a stricter national measure was that Sweden is experiencing a significant and prolonged build-up and intensification of systemic risk related to the housing market. While growth in house prices has decelerated, house prices remain overvalued and household indebtedness, mainly consisting of mortgage loans, is still increasing.[10] A shock to house prices or interest rates continues to potentially cause serious problems for both the financial system and the Swedish

[9] See Recommendation ESRB/2018/8 of 5 December 2018, https://www.esrb.europa.eu/pub/pdf/recommendations/2019/esrb.amendment190211_2015_2.en.pdf

[10] See Recommendation ESRB/2019/9 of 27 June 2019 on medium-term vulnerabilities in the residential real estate sector of Sweden and the ESRB's report entitled "Vulnerabilities in the EU residential real estate sector", September 2019.

economy at large. Therefore, the resilience of credit institutions is important so that they can withstand shocks without excessively restricting the credit supply.

Furthermore, average risk weights at the portfolio level are assessed to not fully capture the credit risk in the Swedish mortgage loan market. Credit losses realised on Swedish mortgage loans have been very low for a long period of time. Therefore, FI considers that IRB models – whose parameters are based on historical observations – do not fully reflect the systemic risk related to increased house prices and household indebtedness.

Section 2: Analysis of the underlying systemic risks

In its recommendation of 27 June 2019, the ESRB recommended that the Swedish national authorities monitor vulnerabilities and activate or tighten macroprudential measures. While the ESRB's assessment in 2019 revealed that, since 2016, the growth in house prices had decelerated, they remained overvalued and household indebtedness had increased significantly.

2.1 Vulnerabilities in the residential property sector

While growth in house prices has decelerated, RRE prices in Sweden remain overvalued. RRE prices increased by 8.1% year on year in August 2020, according to Valueguard's HOX index, with a concentration in housing. RRE prices increased by 6.5% between the second quarter of 2018 and the second quarter of 2020, a deceleration from the 30% increase up to the third quarter of 2017.[11] Since then, the growth rate in prices has decelerated.[12] Nonetheless, widely used indicators of potential overvaluation, such as the price-to-income ratio and the price-to-rent ratio, as well as model-based approaches show signs of significant overvaluation in the RRE market, in the range of 30% to 50%.[13] In view of this overvaluation and the COVID-19-related economic downturn, there is a non-negligible risk of a stronger price correction in the RRE sector.

The increase in house prices has been supported by good access to mortgage loans and the low interest rate environment. In recent years, the low interest rate environment has contributed to RRE price increases and growing credit dynamics at the pace of approximately 5.4% per annum.[14] **Uncertainty in the housing market has increased, notably in the light of high uncertainty regarding the economic impact of the COVID-19 pandemic.** The impact of COVID-19 on the housing market is still highly uncertain. In particular, if the economic downturn triggered by COVID-19 translates into higher unemployment rates and overall loss of income, this could

[11] See the ESRB risk dashboard, March 2018, Chart 3.13.

[12] See the "Financial Stability Report", Sveriges Riksbank, 2020:1, Chart 21.

[13] See the ESRB risk dashboard, June 2020, Chart 3.12. For a detailed description of the methodology, see Box 3 of the "Financial Stability Review", ECB, November 2015.

[14] For an overview of annual growth rates of loans of monetary financial institutions (MFIs) to households, see the ESRB risk dashboard, June 2020, Chart 3.1.

lead to households being overburdened by their (already high) debt levels. This, in turn, could lead to forced sales, thereby weighing on house prices. However, no such trend is yet observable. At the same time, the pandemic may have increased demand for different segments of housing, thereby increasing prices in these particular segments.

The majority of residential mortgages have floating interest rates, which makes the RRE market more sensitive to interest rate changes. Approximately 60% of residential mortgage loans have floating interest rates. In combination with elevated household indebtedness, this makes Swedish households sensitive to interest rate increases, for example related to changes in the global economic outlook, or sudden interest rate shocks that could be linked to financial market turbulences.

2.2 Vulnerabilities in the household sector

The main vulnerability of the Swedish financial system is the high and increasing level of household indebtedness. The ratio of household debt to gross disposable income was 175% in the fourth quarter of 2019; this is among the highest in the EU and is largely driven by strong residential mortgage borrowing.[15] Household indebtedness, as measured, for example, by the debt-to-income (DTI) ratio, remained at elevated levels (209%).[16] The average LTV ratio was 65.5% and a substantial share of mortgages (51%) granted have a relatively high LTV ratio (higher than 70%).[17] Currently, almost half of the existing stock of mortgage loans has an LTV ratio of 70%-85%.[18]

Although households' margins are sound, they are at risk in a scenario of rising interest rates. On average, households with new mortgage loans have a surplus of approximately 38% of their disposable income after mortgage expenses, which is to some extent a reflection of low interest rates.[19] Given that 60% of mortgage loans have floating interest rates, mortgage expenses and household indebtedness are sensitive to interest rate changes. At the current interest rates, approximately 9% of households with new mortgages have less than SEK 5,000 left over every month, given their actual interest rate and amortisation payments and after accounting for living expenses. Furthermore, if interest rates were to increase to approximately 7%, the share of households with a surplus of less than SEK 5,000 each month would be 31% of households with new mortgage loans.[20]

[15] See the ESRB risk dashboard, June 2020, Chart 2.10.

[16] See "Stability in the Financial System", Finansinspektionen, 2 April 2020.

[17] See "The Swedish Mortgage Market", Finansinspektionen, 2 April 2020. See also the ESRB risk dashboard, June 2020, Chart 2.10.

[18] See the "The Swedish Mortgage Market", Finansinspektionen, 2 April 2020, Chart 5.

[19] See "The Swedish Mortgage Market", Finansinspektionen, 2 April 2020, Chart 22. The average mortgage interest rate is approximately 2% (this was the average for the years 2015-17); see "The Swedish Mortgage Market", Finansinspektionen, 4 April 2018, note to Chart 28.

[20] See "The Swedish Mortgage Market", Finansinspektionen, 2 April 2020, Chart 23.

Household credit growth remained strong, at an annual growth rate of 5.4% in March 2020. Mortgages are the primary driver behind the development in household debt, with an annual growth rate of 5.3% in March 2020. The amortisation requirement introduced in Sweden in 2016 and the stricter amortisation requirement introduced in 2018 have increased amortisation payments. However, between 2018 and 2019, the average amortisation rate remained unchanged around 2.2%.[21]

2.3 Vulnerabilities in the banking sector

Swedish banks are significantly exposed to the RRE sector. The banking sector supplies the large majority of residential mortgage loans in Sweden. According to FI data, IRB credit institutions account for 95% of the total mortgage market, making them fundamental for the supply of mortgages to households. Mortgages account for 82% of total lending by monetary financial institutions to households, and around 70% of Swedish GDP. For the three major banks, mortgage loans to households constitute 50% of their total lending, making them vulnerable to negative developments in the RRE market.

Overall, the Swedish banking sector has a relatively good solvency position and risk weights for mortgage loans are relatively high, as compared to other Member States with vulnerabilities in the RRE sector, owing to the floor of 25% currently applied via Article 458 of Regulation (EU) No 575/2013. The average Tier 1 capital ratio of the Swedish banking system was at 19% in the first quarter of 2020, above the EU average of 16%. Swedish banks also have a low ratio of non-performing loans, at 1% on average.[22] The average IRB risk weight for mortgage loans in Sweden is 25% (applied via Article 458). Without the measure, the risk weights would range from 3.1% to 13.6% for the largest nine IRB banks (accounting for around 90% of the total mortgage market in Sweden).

The bank funding structure may constitute vulnerability on the liquidity side, also in view of the high degree of interconnectedness and exposure to the RRE market via covered bonds. Swedish banks have a large share of wholesale funding, of which a significant part is denominated in foreign currency. The major banks are closely interconnected and have significant exposures towards each other, particularly in the form of securities. For example, Swedish banks are among the largest owners of each other's covered bonds.[23] Consequently, adverse developments in the Swedish RRE sector could affect Swedish banks beyond their direct loan exposures through both the liability side, in the form of funding constraints, and via the asset side, in the form of the repricing of covered bonds.

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[21] See "The Swedish Mortgage Market", Finansinspektionen, 2 April 2020, Charts 17.

[22] See the "Risk dashboard", European Banking Authority, 2020-Q1, Section 4.1.

[23] See the "Financial Stability Report", Sveriges Riskbank, 2020:1, Chart 28.

Section 3: Effectiveness and efficiency of the measure

3.1 How the measure addresses the identified risk

The measure is part of a wider set of initiatives that have been introduced over several years to address concerns about the developments in the Swedish RRE sector (see Section 1.2).

The calibration of the minimum risk weight at 25%, which is kept unchanged in the proposed measure, was assessed by the ESRB on 21 June 2018 as an appropriate and sufficient policy measure related to the banking stretch of the RRE vulnerabilities in Sweden. Previously, the Pillar 2 measure introduced a risk-weight floor in May 2013, which was recalibrated to 25% in September 2014.[24] Following the introduction of the Article 458 measure in 2018, in its report entitled “Vulnerabilities in the EU residential real estate sector” of September 2019 and its recommendation of 27 June 2019, the ESRB assessed the macroprudential policy mix to ensure a robust level of bank capital buffers.

The draft measure does not primarily seek to address the risks related to the key vulnerabilities of high and increasing household indebtedness, nor of RRE price developments. Vulnerabilities on the household side were addressed by FI through measures such as the LTV of 85% and the amortisation requirements, the latter linked to both the LTV of the mortgage and the LTI of the borrower. With the draft measure, these risks are addressed indirectly by maintaining the resilience of banks in the event of a possible downturn in the RRE sector and declining credit quality of residential mortgage loan portfolios.

3.2 How the measure relates to possible alternatives

As required under Article 458 of the CRR, this section assesses whether other macroprudential instruments available under Directive 2013/36/EU and the CRR could adequately address the increase in systemic risk, taking into account their relative effectiveness. These instruments need to be considered before resorting to Article 458 of the CRR to adopt stricter national measures.[25] The ESRB’s assessment of the original measure already analysed this question. The main arguments why these other measures are not considered to be appropriate alternatives to the envisaged extension of the measure under Article 458 CRR remain the same.

a) Increasing the risk weights for banks applying the standardised approach to credit risk (Article 124 of the CRR as amended by CRR II)

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

[24] For details on the calibration, see “Risk Weight Floor for Swedish Mortgages”, Finansinspektionen, May 2013 and “Capital Requirements for Swedish Banks”, Finansinspektionen, September 2014.

[25] Under Article 458 of the CRR as amended by CRR II, as from 28 December 2020, an assessment of why Articles 101, 103, 104 and 105 cannot adequately address the macroprudential and systemic risk identified will no longer be required.

As 95% of the Swedish mortgage market exposures are held by credit institutions applying the IRB approach and the IRB risk weights are relatively low, Article 124 of the CRR would not be effective in meeting the measure's objectives. Furthermore, the risk weight of 35% under the standardised approach is considered sufficient compared with the proposed risk-weight floor of 25% for IRB credit institutions.

b) Increasing the loss given default (LGD) floor for banks applying the IRB approach for credit risk (Article 164 of the CRR as amended by CRR II)

Relevant authorities can set higher minimum values of exposure-weighted average LGD for exposures secured by property, on the basis of financial stability considerations. The exposure-weighted average LGD for all retail exposures secured by residential property and not benefiting from guarantees from central governments must not be lower than 10%.[26] The LGD is one of the parameters used in the risk-weight function. Increasing the LGD indirectly increases the risk weight and the resulting capital requirements.

The average risk weights of Swedish IRB credit institutions in the absence of the measure would range from 3.1% to 13.6%; this is due to very low credit losses observed over a long period of time. Furthermore, the average risk weight of all Swedish IRB banks is only 4.5%. Credit risk models for Swedish mortgage loans often generate such low risk weights due to very low historical credit losses. FI considers that such low risk weights do not fully capture the potential credit losses of Swedish mortgages in a severe downturn scenario.

The differences in the estimation of risk weights reflect the individual conservativism of credit institutions in the estimation of the probability of default (PD), and do not necessarily reflect differences in the risk profile of borrowers. The low levels of historic credit losses affect both the estimation of PDs and LGDs in the IRB approach. Individual credit institutions apply a different degree of conservatism when estimating the PDs of borrowers.

Increasing the LGD floor for mortgages would widen these differences in risk weights between IRB credit institutions and could result in a disproportionate increase in risk weights for some of them. As the IRB risk-weight formula is a linear function of the LGD parameter, increasing the latter leads to a larger increase in risk weights for more conservative banks with higher PD estimates. Moreover, in order to achieve the same impact as a 25% risk-weight floor, the LGD floor would need to be set above 50% (i.e. a five-fold increase). In FI's view, such an increase is not justified.

Consequently, the risk-weight floor addresses the objective more adequately and effectively than a measure under Article 164 of the CRR. It avoids a disproportionate increase of risk weights among IRB credit institutions. Furthermore, an increase in the LGD floor would impact the calculation of expected loss under Articles 158 and 159 of the CRR. Additionally, it would add further complexity and reduce market transparency of IRB risk weights for market participants. In FI's view, systemic risks should not be explicitly taken into account in internal models.

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[26] Article 164(4) of the CRR.

c) Using the systemic risk buffer (Article 133 of Directive 2013/36/EU)

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. In Sweden, a SyRB of 3% already applies to all exposures of the three largest banks, addressing the risk of a large, concentrated and interconnected banking system.

The draft measure aims to limit the risk of a severe cyclical downturn in the RRE market, and thus the SyRB would not be applicable. The SyRB can only be used to address non-cyclical risks. The Swedish mortgage market and the RRE sector display certain vulnerabilities of a structural nature. Nevertheless, FI adopted the measure in response to the elevated and increasing cyclical risks in the RRE market.

Even once Directive (EU) 2019/878[27] becomes applicable and allows for the application of a sectoral SyRB, which may be designed in a way that it targets exposures in the RRE market, such sectoral SyRB would not address the identified risk to the same extent. While CRD V entering into force on 29 December 2020 will introduce the possibility of a sectoral SyRB, this was not considered to be an adequate alternative. FI informed the ESRB that the main reasons were that it would penalise IRB banks with the most conservative assumptions, small differences in risk weights could be significantly amplified in the resultant capital add on, and clear communication and reciprocity would be difficult. Moreover, to achieve the same capital-increasing effect as the 25% risk-weight floor, a sectoral SyRB would need to be set around 100% for those exposures which (without the floor) would have the lowest risk weights. This shows that the sectoral SyRB at a level foreseen in the CRD V[28] is not able to achieve the same result as the risk-weight floor.

d) Using the countercyclical capital buffer (Article 136 of Directive 2013/36/EU)

CRD IV introduced the countercyclical capital buffer (CCyB) to address some of the procyclicality in the financial system. The CCyB is a requirement applicable to domestic exposures. The rate for the CCyB is set on a quarterly basis by the designated authority. Designated authorities follow a specific methodology based on an ESRB recommendation.[29] FI has recently lowered the buffer from 2.5% to 0% to address the potential impact of COVID-19.

The CCyB is not an appropriate tool to address a targeted systemic risk, as it would apply to all exposures in Sweden and not only to Swedish mortgage loans. The CCyB addresses cyclical risks and is

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[27] Directive 2019/878 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 June .2019, p. 287).

[28] The CRD V provides for an enhanced notification procedure if the combined systemic risk buffer rate is at a level higher than 3% and up to 5%, and for the need to seek approval by the European Commission, if this rate is above 5%. This demonstrates that already a level of 5% of (sectoral) SyRB would be considered high.

[29] See Recommendation ESRB/2014/1 on guidance for setting countercyclical buffer rates.

based on the relationship between growth in total lending and GDP growth. Furthermore, as described in Section 2, the draft measure addresses both cyclical and structural risks of Swedish mortgage loans. The CCyB would not appropriately target the risk identified by the Swedish authorities, as it would also penalise exposures to non-financial corporations.

e) Using Pillar 2 (Articles 103, 104 and 105 of the Directive 2013/36/EU)

Relevant 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.

With CRD V applying from 29 December 2020 onwards, the current Article 103 (Application of supervisory measures to institutions with similar risk profiles) is no longer available.

Pillar 2 measures are of a microprudential nature as foreseen in CRD V, while the risk is macroprudential. The identified risks and vulnerabilities of the Swedish RRE market are clearly not an idiosyncratic risk relating to the individual risk profile for a given institution.

f) Using Article 101 of Directive 2013/36/EU (Ongoing review of the permission to use internal approaches)

- **Use of Article 101 of Directive 2013/36/EU is not justified**: FI considers that Swedish credit institutions using the IRB approach do not breach CRR requirements when modelling Swedish mortgage loans. The models are based on long time series of historical data. The low risk-weight estimates are due to low levels of historically observed losses and not due to flaws in the modelling framework. While FI continues to review the IRB models for Swedish mortgages so as to ensure a sufficient cycle and downturn adjustment for the calibration of PD and LGD, these measures are not expected to increase the risk weights sufficiently close to 25%.

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 maintain the resilience of the affected banks, though further developments regarding the vulnerabilities in the RRE sector in Sweden need to be monitored closely, in particular in the context of the impact of COVID-19. Assuming that the measure is fully reciprocated by Member States which have credit institutions with material exposures to the Swedish RRE market, the capital requirements for the IRB credit institutions should remain broadly the same in terms of nominal amounts. In view of the elevated and increasing vulnerabilities in the Swedish RRE sector (see Section 2), further developments need to be monitored closely and the policy stance may need to be further adjusted.

Since the proposed measure does not materially change the capital requirements in nominal terms, its impact on banks' funding costs, loan margins and economic growth can be expected to be limited. The design of the measure implies keeping the current nominal capital requirements unchanged, provided that the

measure is reciprocated. Consequently, the impact of the measure on banks' funding costs, loan margins and economic growth can be expected to be limited, as long as the calibration is not materially adjusted.

Overall, the ESRB has concluded that the proposed measure would not entail disproportionate adverse effects for the internal market or other national financial systems. The measure should further maintain the resilience of Swedish banks to shocks in the Swedish RRE market and thus reduce potential channels for contagion from Sweden to other Member States. As the measure is an extension of the measure which is already in place since December 2018, it should not introduce any disproportionate adverse effects for the internal market or other national financial systems. Members of the ESRB General Board did not raise any material concerns under the procedure laid down in Article 4 of Decision ESRB/2015/4, as far as negative externalities of the measure in terms of adverse cross-border spillover effects were concerned.

4.2 Effects on both domestic and cross-border lending

The ESRB does not expect the draft measure to materially affect domestic and cross-border lending, given that no material impact of the current Article 458 measure has been shown in the past.

RRE loans to households have increased by around 11% from the first quarter of 2018 to the first quarter of 2020. Residential mortgage lending growth has been robust in Sweden and stood at around 6% mid-2020, similar to the growth rate observed in mid-2018.

Spillovers to other categories of lending to households and to non-financial corporations in Sweden appear to be limited. The share of RRE loans in total loans to households stands at around 53% and has hardly changed between the first quarter of 2018 and the first quarter of 2020.

Non-bank institutions have been entering the Swedish mortgage market only very recently and their market share is still negligible.[30] Direct investments in mortgages by Swedish insurers and pension funds are negligible.[31] However, FI noted that insurers and pension funds show interest in indirect investments through mortgage funds, in addition to their investments in covered bonds. While new players such as independent loan brokers and investment funds have entered the market in recent years, their market share remains low (below 1%).

Nonetheless, Sveriges Riksbank noted in its December 2017 Financial Stability Report that these new entrants could complicate macroprudential policy. These new players fall outside the scope of existing macroprudential instruments. For example, they may be subject to lower capital requirements than Swedish banks on the basis of the risk-weight floor, or may not be subject to the amortisation requirement. Therefore, the Swedish authorities should continue monitoring developments, closely assess the effectiveness of macroprudential policy measures and, if necessary, update their macroprudential toolkit.

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[30] See the article entitled “New players on the mortgage market” in the **Financial Stability Report 2018:1**, Sveriges Riksbank, pp. 31-34.

[31] See also Box 5 in the EIOPA **Financial Stability Report, December 2017**.

Foreign banks represented around 17% of new Swedish mortgage loans at the end of the first quarter of 2020. For the same banks, the share stood around 13% at the end of the first quarter of 2018. Based on available consolidated banking statistics provided by the Bank for International Settlements, the loan stocks of foreign banks in Sweden have not changed since the introduction of the measure, save for the usual business fluctuations.

4.3 Effects on intragroup behaviour of credit institutions

Given that credit institutions already meet the higher capital requirement, it is unlikely that the measure will cause a significant shift of operations within their group structures. Moreover, no significant changes in intragroup behaviour of relevant credit institutions have been observed since the introduction of the measure.

FI has also asked the ESRB to recommend that other Member States with material exposures continue to reciprocate the measure. FI emphasised that reciprocity remains relevant as these countries' banking sector may be exposed directly or indirectly through their branches to the risk related to the real estate market in Sweden.

The development of cross-border mortgage lending and lending through branches should therefore be monitored. Further investigation of developments at the level of individual institutions (in particular by the supervisory colleges of the banking groups concerned) should occur if there is a significant pick-up in such activity.

Conclusions

The main purpose of the extension of the measure is to continue addressing the risk of asset bubbles in the residential property sector and their potential spillover effects. The ESRB concluded in its recommendation of 27 June 2019 that macroprudential measures in Sweden were appropriate.

The assessment is made against the backdrop of signs that vulnerabilities in the Swedish RRE market continue to increase. In its warning of 22 September 2016 and its recommendation of 27 June 2019[32], the ESRB identified the main medium-term vulnerabilities in the RRE sector in Sweden to be increasing residential property prices, resulting in an overvaluation of the market, as well as high and increasing indebtedness, particularly among some groups of households. Overall, while the growth rate in residential property prices has decelerated over recent years, prices remain overvalued such that these concerns still remain valid and there is evidence of further increasing vulnerabilities, for example related to increasing household indebtedness.

[32] See the warning of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of Sweden and the recommendation of the European Systemic Risk Board of 27 June 2019.

These vulnerabilities are likely to amplify in the light of the uncertain negative impact of the COVID-19 pandemic and the related economic downturn. The ESRB is of the view that the current economic crisis triggered by the COVID-19 pandemic intensifies the risks in the corporate sector across the EU and globally. Given these circumstances, household debt is likely to increase further over the coming quarters. The ESRB is of the view that the proposed extension of the measure does not contradict the overall aim of guaranteeing lending to the real economy throughout the aforementioned economic crisis. Clear communication in this respect is important, explaining to the public that the extension of the measure is consistent with other measures taken in response to the COVID-19 pandemic.

The ESRB is further of the view that the alternative macroprudential instruments listed in Article 458 of the CRR, which must be considered before any stricter national measure can be taken, would not be adequate to address the risk at hand. Measures such as those listed in Articles 124 and 164 of the CRR, as well as the systemic risk buffer or the countercyclical capital buffer, are considered to be inadequate, as they do not provide the intended incentives, are too broad-based, or do not, to the same extent, address the risk, exposure or credit institution. The ESRB also found that the measure does not entail disproportionate adverse effects on the internal market or other national financial systems.

Therefore, the ESRB is of the view that the stricter measure is justified, proportionate, effective and efficient for the purpose mentioned above. However, this assessment has been made for the specific purposes of the procedure under Article 458 of the CRR and does not prejudge the outcome of the review of the recommendation of 27 June 2019.

In addition, the ESRB would like to highlight the following points:

First, the effectiveness of the measure will depend on the extent to which it will continue to be reciprocated by other Member States with credit institutions active in the Swedish residential mortgage market. In this respect, the ESRB's recommendation to reciprocate the existing measure[33] continues to apply to the measure in its extended form.

Second, the measure should be reconsidered once the implications of the COVID-19 pandemic on the Swedish residential real estate market and on the indebtedness of households become clearer. Currently, the impact is surrounded by high uncertainty and can, hence, not be reliably assessed.

The ESRB therefore supports FI's intention to extend the period of application of its stricter national measure. At the same time, the ESRB reiterates that the issues raised in its assessment of the original measure require continued follow-up by the Swedish authorities to ensure the effectiveness of the measure and avoid unwarranted consequences.

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[33] See Recommendation ESRB/2015/2 on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures.