RECOMMENDATION OF THE EUROPEAN SYSTEMIC RISK BOARD

of 27 June 2019

on medium-term vulnerabilities in the residential real estate sector in Finland

(ESRB/2019/8)

THE GENERAL BOARD OF THE EUROPEAN SYSTEMIC RISK BOARD,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board[1], and in particular Articles 3, 16, 17 and 18 thereof,

Whereas:

(1) The real estate sector plays an important role in the economy and its developments may have a material influence on the financial system. Past financial crises have demonstrated that unsustainable developments in real estate markets may have severe repercussions on the stability of the financial system and of the economy as a whole, which may also lead to negative cross-border spillovers. Adverse real estate market developments in some Member States have, in the past, resulted in large credit losses and/or had a negative impact on the real economy. Such effects reflect the close interplay between the real estate sector, funding providers and other economic sectors. Furthermore, the strong feedback loops between the financial system and the real economy reinforce any negative developments.

(2) These links are important because they mean that risks originating in the real estate sector may have a systemic impact that is procyclical in nature. Financial system vulnerabilities tend to accumulate during the upswing phase of the real estate cycle. The perceived lower risks of, and easier access to, funding may contribute to a rapid expansion of credit and investment, together with an increased demand for real estate, which puts upward pressure on property prices. Since the resulting higher collateral values further favour the demand for, and supply of, credit, these self-reinforcing dynamics may result in potential systemic consequences. Conversely, during the downturn phase of the real estate cycle, tighter credit conditions, higher risk aversion and downward pressure on real estate prices may adversely affect the resilience of borrowers and lenders, thereby weakening economic conditions.

(3) Vulnerabilities relating to residential real estate can be a source of systemic risk and they may affect financial stability both directly and indirectly. Direct effects are credit losses on mortgage portfolios due to adverse economic or financial conditions and simultaneous

1 OJ L 331, 15.12.2010, p. 1.

negative developments in the residential real estate market. Indirect effects could be related to adjustments in household consumption, leading to further consequences for the real economy and financial stability.

(4) As stated in recital 4 of Recommendation ESRB/2013/1[2], the ultimate objective of macroprudential policy is to contribute to the safeguard of the stability of the financial system as a whole, including by strengthening the resilience of the financial system and decreasing the build-up of systemic risks, thereby ensuring a sustainable contribution of the financial sector to economic growth.

(5) To this end, macroprudential authorities may use one or more of the capital-based macroprudential measures set out in Directive 2013/36/EU of the European Parliament and of the Council[3] and Regulation (EU) No 575/2013 of the European Parliament and of the Council[4], and/or borrower-based macroprudential measures, which are exclusively based on national law, depending on the assessment of risks. While the capital-based measures are primarily aimed at increasing the resilience of the financial system, the borrower-based measures may be particularly suitable for preventing the further build-up of systemic risks.

(6) In addition, Recommendation ESRB/2013/1 recommends that Member States establish a legal framework that permits the macroprudential authorities to have direct control or recommendation powers over the macroprudential instruments identified in that Recommendation.

(7) In 2016, the European Systemic Risk Board (ESRB) conducted a Union-wide assessment of the vulnerabilities relating to residential real estate[5]. This assessment enabled the ESRB to identity a number of medium-term vulnerabilities in several countries as sources of systemic risk to financial stability, which led to the issuance of warnings to eight countries, of which Finland was one[6].

(8) In 2016 the main vulnerability identified in the residential real estate market in Finland was high and increasing household indebtedness, with a significant share of households being potentially vulnerable to adverse economic or financial conditions or adverse developments in that market.

---

2 Recommendation ESRB/2013/1 of the European Systemic Risk Board of 4 April 2013 on intermediate objectives and instruments of macro-prudential policy (OJ C 170, 15.6.2013, p. 1).

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).

4 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).

5 See 'Vulnerabilities in the EU Residential Real Estate Sector', ESRB, November 2016, available on the ESRB's website at www.esrb.europa.eu.

6 Warning ESRB/2016/08 of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of Finland (OJ C 31, 31.1.2017, p. 49).

(9) The ESRB has recently concluded a systematic and forward-looking European Economic Area (EEA)-wide assessment of vulnerabilities relating to residential real estate[7].

(10) As regards Finland, this recent assessment has revealed that household indebtedness is higher than it was in 2016. Recently, this increase has partly been accounted for by loans taken out by housing companies[8] and then repaid from the income of households and other investors holding shares in these companies. In addition, newly available evidence regarding lending standards for new mortgage loans supports previous evidence of the potential vulnerability of a significant share of households taking out new mortgage loans to adverse economic or financial conditions or adverse developments in the residential real estate market.

(11) Since 2016, the Finnish national authorities have tightened or introduced several borrower- and capital-based measures: (i) in 2017 the Board of *Finanssivalvonta* (the Finnish Financial Supervisory Authority) introduced, pursuant to Article 458 of Regulation (EU) No 575/2013, an average risk weight floor of 15 % for housing loans for credit institutions that use the internal ratings-based approach; (ii) in 2018 a systemic risk buffer of between 1 % and 3 % was imposed on all credit institutions; (iii) in 2018 the limit that applies to the loan-to-value (LTV) ratio was tightened from 90 % to 85 %; and (iv) also in 2018, *Finanssivalvonta* issued recommendations concerning lending standards for new loans, which also applied to loans to housing companies. In addition, the tax deductibility of mortgage interest expenses was reduced, from 100 % in 2011 to 25 % in 2019.

(12) Despite these recently introduced measures, and except for the limit that applies to the LTV ratio, other legally binding borrower-based measures, namely limits that apply to the debt-to-income (DTI) ratio, the debt-service-to-income (DSTI) ratio and, maturity limits, are still not available in Finland, even though such measures may be necessary in the medium term if vulnerabilities related to household indebtedness continue to increase. Activating the limits that apply to either the DTI ratio or the DSTI ratio, in combination with maturity limits, would increase the effectiveness of the existing macroprudential measures that are already in place. Furthermore, the LTV ratio is currently defined in a manner that allows assets other than real estate assets to be considered as collateral.

(13) Therefore, the ESRB has concluded that the macroprudential measures that are in place or available in Finland are partially appropriate and partially sufficient to address the vulnerabilities related to household indebtedness in the medium term. Consequently, further policy action is required to address these vulnerabilities, which can be a source of systemic risk. The measures proposed in this Recommendation are aimed at complementing the existing macroprudential measures in Finland.

(14) The purpose of this Recommendation is to recommend the inclusion in Finnish law of additional legally binding borrower-based measures, as well as the adoption of such measures to prevent the vulnerabilities related to household indebtedness from increasing.

---

7 See 'Vulnerabilities in the residential real estate sectors of EEA countries', ESRB, 2019, available on the ESRB's website at www.esrb.europa.eu.

8 In Finnish: asunto-*osakeyhtiö*.

(15) This Recommendation is without prejudice to the monetary policy mandates of the central banks in the Union.

(16) ESRB recommendations are published after the General Board has informed the Council of the European Union of its intention to do so and provided the Council with an opportunity to react, and after the addressees have been informed of the intention to publish,

HAS ADOPTED THIS RECOMMENDATION:

SECTION 1

RECOMMENDATIONS

Recommendation A – Legal framework for borrower-based measures

1. It is recommended that Finland ensure that the existing legal framework for borrower-based measures includes at least the following legally-binding borrower-based measures:
    a. either limits that apply to the DTI ratio or limits that apply to the DSTI ratio;
    b. limits that apply to the LTV ratio; and
    c. maturity limits.
2. It is recommended that Finland amend the definition of the LTV ratio in the existing legal framework for borrower-based measures.

Recommendation B – Activation of income-related borrower-based measures

1. It is recommended that, pending the amendment of the existing legal framework as referred to in Recommendation A, the Finnish national authorities entrusted with the activation of income-related borrower-based measures apply non-legally-binding borrower-based measures in order to prevent a significant or an increasing share of borrowers taking out new mortgage loans who might not be able to service their debt or maintain consumption following adverse economic or financial conditions or adverse developments in the residential real estate market.
2. It is recommended that, once the existing legal framework has been amended as referred to in Recommendation A, the Finnish national authorities entrusted with the activation or calibration of income-related borrower-based measures activate or calibrate, respectively, legally binding income-related borrower-based measures to further address the objectives set out in sub-recommendation B(1).

SECTION 2

IMPLEMENTATION

1. Definitions

For the purposes of this Recommendation the following definitions apply:

(a) 'borrower-based measures' means macroprudential measures that target borrowers;

(b) 'direct control' means a real and effective capacity to impose and modify, where necessary to achieve an ultimate or intermediate objective, macroprudential measures applicable to the financial institutions that are under the scope of action of the corresponding macroprudential authority;

(c) 'recommendation powers' means the capacity to guide, by means of recommendations, the application of macroprudential instruments, where necessary to achieve an ultimate or intermediate objective;

(d) 'loan-to-value ratio' (LTV ratio) means the sum of all loans or loan tranches secured by the borrower on the immovable property at the moment of loan origination relative to the value of the property at the moment of loan origination;

(e) 'legally binding borrower-based measures' means borrower-based measures that are introduced through legally binding acts;

(f) 'debt-to-income ratio' (DTI ratio) means the total debt of the borrower at the moment of loan origination relative to the borrower's total annual disposable income at the moment of loan origination;

(g) 'debt-service' means the combined interest and principal repayment on a borrower's total debt over a given period (generally one year);

(h) 'debt-service-to-income ratio' (DSTI ratio) means the annual total debt service relative to the borrower's total annual disposable income at the moment of loan origination;

(i) 'maturity' means the duration of the residential real estate loan contract expressed in years at the moment of loan origination;

(j) 'medium term' means within a three-year horizon;

(k) 'income-related borrower-based measures' means limits that apply to the DTI ratio and limits that apply to the DSTI ratio;

(l) 'macroprudential authority' means a national macroprudential authority with the objectives, arrangements, powers, accountability requirements and other characteristics set out in Recommendation ESRB/2011/3[9].

2. Criteria for implementation

1. The following criteria apply to the implementation of this Recommendation:

(a) due regard should be given to the principle of proportionality, taking into account the objective and content of Recommendation A and of Recommendation B;

(b) Recommendation A must be implemented before sub-recommendation B(2) to ensure compliance with sub-recommendation B(2);

9 Recommendation ESRB/2011/3 of the European Systemic Risk Board of 22 December 2011 on the macro-prudential mandate of national authorities (OJ C 41, 14.2.2012, p. 1).

(c) when activating income-related borrower-based measures under Recommendation B, their calibration and phasing-in should take into account the position of Finland in the economic and financial cycles, and any potential implications as regards the associated costs and benefits;

(d) specific criteria for compliance with Recommendation A and with Recommendation B are set out in Annex I.

2. The addressees of this Recommendation are requested to report to the ESRB and to the Council on the actions undertaken in response to this Recommendation, or adequately justify any inaction. The reports should as a minimum contain:

(a) information on the substance and timeline of the actions undertaken;

(b) an assessment of the vulnerabilities related to household indebtedness and lending standards for new mortgage loans, including the distribution of new mortgage loans according to their LTV, DTI and DSTI ratios, and maturities, with the relevant ratios being calculated in accordance with Annex IV to Recommendation ESRB/2016/14 of the European Systemic Risk Board[10], together with the functioning of the actions undertaken, having regard to the objectives of this Recommendation;

(c) a detailed justification of any inaction or departure from this Recommendation, including any delays.

3. Timeline for the follow-up

The addressees of this Recommendation are requested to report to the ESRB and to the Council on the actions taken in response to this Recommendation, or adequately justify any inaction, in compliance with the following timelines:

(a) *Recommendation A*

(i) By 31 October 2020, the addressee of Recommendation A is requested to submit to the ESRB and to the Council an interim report on the implementation of Recommendation A including at least a statement clarifying whether it is planned that Recommendation A be implemented and which body or bodies will be responsible for the decision to activate and implement the borrower-based measures set out in that Recommendation. The ESRB may inform the addressee of Recommendation A of its views on the interim report.

(ii) By 31 March 2021, the addressee of Recommendation A is requested to submit to the ESRB and to the Council a final report on the implementation of Recommendation A.

(b) *Recommendation B*

By 31 October 2020, and yearly thereafter until 31 October 2022, the addressees of Recommendation B are requested to deliver to the ESRB and to the Council a report on any

10 Recommendation ESRB/2016/14 of the European Systemic Risk Board of 31 October 2016 on closing real estate data gaps (OJ C 31, 31.1.2017, p. 1).

actions taken with regard to implementing income-related borrower-based measures or any other available measures to address the vulnerabilities related to household indebtedness and lending standards for new mortgage loans in Finland. Where there is more than one body responsible for taking actions to address the vulnerabilities identified, one joint report should be submitted.

4. Monitoring and assessment

1. The ESRB Secretariat will:

   (a) assist the addressees, ensuring the coordination of reporting, the provision of relevant templates and detailing, where necessary, the procedure and the timeline for the follow-up;

   (b) verify the follow-up by the addressees, provide assistance at their request, and submit follow-up reports to the General Board. Three assessments will be initiated as follows:

      (i) by 31 December 2020, regarding the implementation of Recommendation B;

      (ii) by 31 December 2021, regarding the implementation of Recommendations A and B; and

      (iii) by 31 December 2022, regarding the implementation of Recommendation B.

2. The General Board will assess the actions and justifications reported by the addressees and, where appropriate, may decide that this Recommendation has not been followed and that an addressee has failed to provide adequate justification for its inaction.

Done at Frankfurt am Main, 27 June 2019.

Francesco Mazzaferro

Head of the ESRB Secretariat, on behalf of the General Board of the ESRB

Francesco MAZZAFERRO

ANNEX I

SPECIFICATION OF COMPLIANCE CRITERIA APPLICABLE TO THE RECOMMENDATIONS

Recommendation A - Legal framework for borrower-based measures

The following compliance criteria are applicable to Recommendation A.

1. The Finnish legal framework for borrower-based measures should ensure that:
   (a) the limits that apply to the debt-to-income (DTI) ratio and to the debt-service-to income (DSTI) ratio, as well as the maturity limits, are applicable to loans granted to all types of borrowers and by all types of lenders, in order to avoid circumvention of the limits by the use of loans to housing companies or other methods;
   (b) when calculating the loan-to value (LTV) ratio, only immoveable property can be considered as collateral;
   (c) the Finnish national authorities entrusted with the activation of borrower-based measures are able to activate legally-binding borrower-based measures in an effective and pre-emptive way and are provided with the necessary flexibility in order to design those measures based on the vulnerabilities identified.
2. The amendments to the Finnish legal framework for borrower-based measures should be in force by no later than 1 July 2021.

Recommendation B – Activation of income-related borrower-based measures

The following compliance criterion is applicable to Recommendation B:

1. In order to prevent a significant or an increasing share of borrowers taking out new mortgage loans who might not be able to service their debt or maintain consumption following adverse economic or financial conditions or adverse developments in the residential real estate market, the Finnish national authorities should use one or several income-related borrower-based measures in combination (e.g. limits to the LTV ratio in combination with limits to the DTI ratio, or to the DSTI ratio, and maturity limits), to ensure the effectiveness of the measures in place and to minimise any potential for their circumvention or for unintended consequences that could reduce their effectiveness and possibly create risks in other areas.
2. Prior to activating income-related borrower-based measures, an assessment should be made of the position of Finland in the economic and financial cycles, in order to determine the appropriate calibration and phasing-in of such measures.
3. After the activation of the income-related borrower-based measures, their further tightening or the activation of additional macroprudential measures may be needed to address the vulnerabilities identified in Finland; this will depend on the choice of the income-related

borrower-based measures activated, on the initial calibration of those activated measures and on the results of the assessment of vulnerabilities.

4. When activating or calibrating the income-related borrower-based measures the Finnish national authorities entrusted with the activation or calibration of income-related borrower-based measures should take into account all loans which are to be serviced by households from their income, regardless of the form of the loans (i.e. treating loans to housing companies as household debt).