RECOMMENDATION OF THE EUROPEAN SYSTEMIC RISK BOARD

of 27 June 2019

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

(ESRB/2019/9)

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

1 OJ L 331, 15.12.2010, p. 1.

mortgage portfolios due to adverse economic or financial conditions and simultaneous 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 Sweden was one[6].

(8) In 2016 the main vulnerability identified in the residential real estate market in Sweden related to the substantial and prolonged growth in both house prices and mortgage loans, which led to an overvaluation of house prices as well as to high and increasing household indebtedness.

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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/2016/11 of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of Sweden (OJ C 31, 31.1.2017, p. 55).

(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 Sweden, this recent assessment has revealed that, since 2016, the growth in house prices has decelerated, and they are currently at the same level as in 2016. However, house prices remain overvalued and household indebtedness has increased significantly.

(11) Since 2016, the Swedish national authorities have tightened or introduced several borrower- and capital-based measures. In 2016, requirements for amortisation of new mortgage loans were introduced. These requirements were linked to the loan-to-value (LTV) ratio of the new loans, requiring amortisation by a minimum of 2 % annually for loans with an LTV ratio above 70 %, and by 1 % annually for loans with an LTV ratio of 50 % to 70 %. In 2017, these requirements were tightened in relation to the loan-to-income (LTI) ratio of the new loans, increasing these requirements by 1 percentage point per year for new mortgage loans with an LTI ratio above 4.5. In 2018, *Finansinspektionen* (the Swedish Financial Supervisory Authority) imposed on all domestic credit institutions that use the internal ratings-based approach, pursuant to Article 458 of Regulation (EU) No 575/2013, a credit institution-specific minimum level (floor) of 25 % for the exposure-weighted average of the risk weights applied to the portfolio of retail exposures to obligors residing in Sweden secured by mortgages on immovable property. Finally, *Finansinspektionen* increased the countercyclical capital buffer rate in 2018 from 2 % to 2.5 %, applicable from September 2019.

(12) While cyclical factors play an important role in fuelling the vulnerabilities that have been identified in Sweden, there are also important structural factors that have driven these vulnerabilities, resulting in a higher level of systemic risk. These factors include: (i) a lack of housing supply, which has been exerting upward pressure on house prices and debt for households that buy their own property; and (ii) the favourable tax treatment of housing, such as the tax deductibility of interest paid on mortgage loans, which may facilitate house price increases and act as an incentive for households to overborrow.

(13) Therefore, despite the fact that the ESRB acknowledges the wide range of macroprudential measures that are in place in Sweden, it has concluded that even though these macroprudential measures are appropriate, they are partially sufficient to address the identified vulnerabilities related to residential real estate, in particular the household indebtedness and overvaluation of house prices, in the medium term. Given that these vulnerabilities are, to some extent, driven by structural factors which go beyond macroprudential policy, other policies are needed to complement and support the current macroprudential measures, with the aim of addressing factors contributing to the build-up of systemic risks in the residential real estate market in Sweden more efficiently and effectively, without producing excessive costs for the Swedish real economy and financial system. The measures proposed in this Recommendation are aimed at complementing the existing macroprudential measures in Sweden.

(14) The purpose of this Recommendation is to recommend: a) broader policy action aiming to curb factors which facilitate or promote increasing household indebtedness; and b) the

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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.

tightening of the existing, or the activation of other, macroprudential measures if the vulnerabilities related to household indebtedness and overvaluation of house prices continue to increase due to cyclical economic and financial reasons.

(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 – Structural changes related to mortgage loans and the residential real estate sector

It is recommended that Sweden review its policies with the aim of curbing the structural factors that have driven the vulnerabilities identified in Sweden as a source of systemic risk as they provide incentives for households to take on excessive mortgage debt, or cause excessive growth in house prices and mortgage debt.

Recommendation B – Monitoring of vulnerabilities and activation or tightening of macroprudential measures

1. It is recommended that the Swedish national authorities entrusted with the monitoring of systemic risks closely monitor vulnerabilities related to household indebtedness and overvaluation of house prices over the medium term, including, inter alia, by:
   a) assessing – using loan-level data for new mortgage loans – the ability of borrowers taking out new housing loans to withstand adverse economic or financial conditions or adverse developments in the residential real estate market; and
   b) assessing potential credit losses on existing mortgage portfolios, as well as potential second-round effects on financial stability in the event of adverse economic or financial developments.
2. It is recommended that, in order to prevent the accumulation of credit risk, the Swedish macroprudential authority entrusted with the activation of borrower-based measures tighten existing, or activate other, borrower-based measures, if the results of the monitoring carried out pursuant to point (a) of sub-Recommendation B(1) provide evidence that a significant or an increasing share of borrowers taking out new housing loans might not be able to service their debt following an adverse economic or financial development.

3. It is recommended that the macroprudential authority, the designated authority or the competent authority in Sweden, as applicable, tighten existing, or introduce other, capital-based measures in order to ensure sufficient capital for mortgage loans granted by credit institutions authorised in Sweden, if the results of the monitoring carried out pursuant to point (b) of sub-Recommendation B(1) provide evidence that potential credit losses on existing mortgage loans in the event of adverse economic or financial conditions or adverse developments in the residential real estate market, as well as credit losses on other loans as a consequence of the decrease in consumption by households with housing loans, have increased due to cyclical, economic and financial factors.

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 a property at the moment of loan origination relative to the value of the property at the moment of loan origination;

(e) 'loan-to-income ratio (LTI 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 borrower's total annual disposable income at the moment of loan origination;

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

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

(h) 'macroprudential authority' means a national macroprudential authority with the objectives, arrangements, powers, accountability requirements and other characteristics set out in Recommendation ESRB/2011/3[8];

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8 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).

(i) '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;

(j) '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;

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

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) as regards Recommendation A, when making policy changes, the phasing-in of such measures should take into account the position of Sweden in the economic and financial cycles, so that these measures do not serve to amplify or trigger the materialisation of accumulated vulnerabilities in the residential real estate sector in Sweden;

(c) when activating or tightening borrower-based or capital-based measures under Recommendation B, their calibration and phasing-in should take into account the position of Sweden 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 overvaluation of house prices, 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[9], 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.

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9 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).

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*

By 31 October 2022, the addressee of Recommendation A is requested to deliver to the ESRB and to the Council a 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 submit to the ESRB and to the Council a report on monitoring vulnerabilities related to household indebtedness and actions taken to address such vulnerabilities. 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 Recommendation B; and
      (iii) by 31 December 2022, regarding the implementation of Recommendations A and 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 – Structural changes related to mortgage loans and the residential real estate sector

The following compliance criterion is applicable to Recommendation A.

When formulating policy options, and before implementing any policy changes, an assessment should be made of the impact of the proposed measures considering the position of Sweden in the economic and financial cycles, to ensure that such measures do not amplify or trigger the materialisation of the accumulated vulnerabilities in the residential real estate sector in Sweden.

Recommendation B – Monitoring of vulnerabilities and activation or tightening of macroprudential measures

The following compliance criterion is applicable to Recommendation B.

Prior to activating other, or tightening existing, macroprudential measures, an assessment should be made of the position of Sweden in the economic and financial cycles in order to determine whether such activation or tightening would be appropriate.