

EBA/Op/2017/04

15 March 2017

Opinion of the European Banking Authority on measures in accordance with Article 458 Regulation (EU) No 575/2013

Introduction and legal basis

On 14 February 2017 the European Banking Authority (EBA) received a notification from the National Bank of Belgium (NBB) of its intention to apply Article 458(9) of Regulation (EU) No 575/2013 of the European Parliament and of the Council (Capital Requirements Regulation – CRR).¹ This was done by making use of Article 458(2)(d) of that Regulation to replace a measure introduced by the NBB in 2014 and subsequently extended until May 2017 to modify capital requirements in order to account for an increase in macroprudential risk.

The EBA's competence to deliver an opinion is based on Article 34(1) of Regulation (EU) No 1093/2010 of the European Parliament and of the Council² and Article 458(4) of the CRR. Article 458 of the CRR requires designated or competent authorities entrusted with the national application of that provision to notify the EBA if the authority identifies changes in the intensity of macroprudential or systemic risk in the financial system that have the potential to have serious negative consequences for the financial system and the real economy in a specific Member State and that the authority considers would be better addressed by means of stricter national measures. Within one month of receiving the notification, the EBA is required to provide its opinion on the points in Article 458(2) CRR to the Council, the Commission and the Member State concerned. In accordance with Article 14(5) of the Rules of Procedure of the Board of Supervisors,³ the Board of Supervisors has adopted this opinion.

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.

² Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority) amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

³ Decision adopting the Rules of Procedure of the European Banking Authority Board of Supervisors of 27 November 2014 (EBA/DC/2011/01 Rev4).

Background to the measure

The notification of the NBB pertains to the replacement of the current measure, which consists of an increase in risk weights for retail exposures secured by Belgian residential immovable property for Belgian Internal Ratings Based (IRB) banks, introduced on the basis of Article 458 CRR in May 2014 and further extended until May 2017. The notification proposes the introduction of a new macroprudential measure based on two components, the first of which consists of the current five percentage point risk weight add-on for IRB banks and the second, more targeted, of which further increases the risk weights for the riskier mortgage loan segments (on the basis of the indexed loan-to-value (LTV) ratio). This additional risk-sensitive element will be applied to mortgage loans with an indexed LTV ratio greater than 80%. In this way, the microprudential 10% loss given default (LGD) floor is, for the sole calculation of the macroprudential capital requirement under Article 458 of the CRR, replaced by a 20% LGD floor, if the indexed LTV ratio is between 80% and 90%, and by a 30% LGD floor if the indexed LTV ratio is greater than 90%. The NBB states that the additional macroprudential capital requirement will be implemented in a way that will not affect microprudential capital requirements and, in particular, the proposed measure will not have an impact on the expected loss (EL) calculation pursuant to Articles 158 and 159 of the CRR or on the determination of risk exposure amount for defaulted exposures pursuant to Article 153(1) of the CRR. It should be noted that the measure does affect minimum Pillar 1 capital requirements that institutions shall satisfy at all times as per Article 92 of the CRR. The additional requirement is not part of the combined buffer, which is only indirectly affected through the increase in risk exposure amount. However, the NBB states that it functions as a macroprudential buffer, as the NBB could decide to release the additional requirement in the event that the risk was to either abate or materialise.

The calibration of the proposed measure is based on an assessment of credit losses under stress scenarios for the real estate market and aims to increase banks' capital requirements sufficiently. The NBB's simulations include a benchmark stress scenario consisting of a multiplication of the default rate by five and an increase in the LGD by 25 percentage points and a complementing scenario that additionally imposes a minimal default rate per institution (through the introduction of a floor on default rates of 4%). The NBB concludes, after these simulations, that the capital buffer for residential real estate exposures of IRB banks might, on average, be insufficient to absorb potential losses in the event of severe stress. Hence, additional requirements may be required to absorb such losses.

The original measure had been notified to the EBA on 1 April 2014 and was introduced following the European Commission's decision not to object, which was notified to the NBB on 28 May 2014.⁴ On 21 January 2016, the EBA received a notification from the NBB that stated its aim to extend the measure. In its Opinion of 19 February 2016,⁵ the EBA did not object to the NBB

⁴ EBA OP-2014-02 Opinion of the European Banking Authority on measures to address macroprudential or systemic risk, 30 April 2014.

⁵ EBA OP-2016-03 Opinion of the European Banking Authority on measures in accordance with Article 458 Regulation (EU) No 575/2013, 19 February 2016.

proposal and the measure was subsequently extended until 28 May 2017. While acknowledging that the increase in house prices and debt levels in combination could pose a threat to the financial stability of banks in Belgium, the EBA in both of its Opinions also raised some issues relating to the calibration of the specific measure and the use of other measures and to the legal basis by which to address the problem. The EBA observed that the issue underlying the macroprudential measure could at least partly and in the longer term be addressed by requiring changes in banks' IRB models, given that risk weights for Belgian IRB institutions were seen as too low; the appropriateness of the risk-weight level in light of a potential worsening of conditions in the Belgian housing market could have been further assessed based on stress tests as part of the Supervisory Review and Evaluation Process (SREP). The governance constraints mentioned by the NBB on the use of Pillar 2 as an alternative measure were recognised but deemed to be outside the scope of the assessment by the EBA as required by Article 458(4) of the CRR under paragraph (2) of that Article.

Opinion on the measure

Economic rationale for the measure

According to the notification submitted by the NBB, the proposed measure comes after the close monitoring of the developments in the Belgian real estate market, the sustainability of household indebtedness and the quality of banks' loan portfolios, which has been undertaken since the introduction of the first macroprudential measure. The NBB intends to address the European Systemic Risk Board (ESRB) warning of November 2016, in which the ESRB identified the main vulnerabilities in the Belgian residential real estate sector.

The NBB has observed that, while default rates on mortgage loans in Belgium have remained fairly stable in the recent past, the housing market has slowed down somewhat. Figures on nominal property prices for 2015 point to an increase in prices in that year, followed by a marked deceleration in the growth rates of real estate prices in 2016. In addition, the estimates based on benchmark valuation measures performed by the NBB indicate the materialisation of a certain degree of overvaluation in the residential real estate market in Belgium, which is currently in the range of 0–10%.

A number of factors could result in increasing credit losses on banks' mortgage portfolios following price decreases for residential real estate, namely the continued expansion of mortgage lending to Belgian households (with a growth rate of around 5.3% in September 2016), as the result of low interest rates; a sharp increase in the debt ratio of households (59.1% of GDP in the third quarter of 2016 compared with 37.4% in Q1 of 2002); and a high proportion of loans in the riskiest segments, especially with regard to the proportion of new loans with high LTV ratios (>90%), which have oscillated around 30% in recent years. These developments were accompanied by the average IRB risk weight for mortgage loans (before taking into account the macroprudential measures) slightly decreasing in 2015, from 9.7% to 9.6%, the average model-based probability of default (PD) declining (from 1.5% to 1.3%) and LGD rising slightly (from 11.2% to 11.4%).

After an analysis of banks' business plans, the NBB expects sustained new mortgage lending in the coming years. This may intensify competition between the main credit institutions, triggering increased risk-taking in the form of further easing of credit standards. Overall, even if a strengthening of credit standards occurs through the shortening of loan maturities, the more recent data indicate that other signals are emerging regarding the loosening of other credit standards (with respect to LTV ratios, debt service to income ratios and margins). The main argument is that, although the previous measure was effective in building up the resilience of the IRB banks, this is no longer sufficient in light of the increasing exposures of the banks and the discontinuation of credit standards tightening in recent years, especially in the riskier loan segments. Indeed, the NBB notes that there has been no reduction in the market share of 'riskier loan segments' since 2015 and, therefore, concludes that the proposed measure not only will provide sufficient capital supply in a severe downturn scenario but also will introduce a behavioural component that further discourages excessive credit risk-taking by IRB banks.

Rationale for not using alternative measures

Regulation (EU) No 575/2013 and Directive 2013/36/EU (CRD) offer various options by which to address banks' vulnerabilities, and Article 458(2)(c) of the CRR requires the designated authority to justify why the stricter national measure is necessary and why other possible measures (i.e. pursuant to Articles 124 and 164 of the CRR and Articles 101, 103, 104, 105, 133, and 136 of the CRD) cannot adequately address the macroprudential or systemic risk identified, taking into account the relative effectiveness of those measures.

The notification provides a comprehensive justification of the NBB decision to deploy Article 458 of the CRR. In particular, it claims that:

- Article 124 of the CRR would not be adequate since it is applicable only to banks using the standardised approach for the exposures towards residential real estate. For such exposures, representing about 5% of the market share at the end of 2015, the 46% risk weight is considered sufficient by the NBB.
- Increasing the exposure weighted average LGD floor for mortgage loans as per Article 164 of the CRR is not pursued, since the proposed measure aims to impose an additional macroprudential capital requirement (rather than using a measure of a microprudential nature) based on a higher LGD floor for each *individual* loan with an LTV above 80%. Increasing the average LGD floor could induce banks to minimise the impact of the measure by imposing a higher LGD on a subset of loans with the lowest PDs.
- Moreover, the proposed macroprudential requirement will not affect banks' internal model, whereas Article 164 would lead to a change in the internal model of banks. The NBB also claims that an increase in the average LGD floor under Article 164 would have implications beyond the calculation of the risk-weighted exposure amounts and would also apply to the calculation of expected loss amounts, for example.

- As regards Articles 102, 103 and 104 of the CRD, the NBB lists a series of arguments against their use in this specific case. First, the proposed measure is to be applied to all banks applying internal models and it is not based on the risk assessment made pursuant to Article 97 of the CRD on an individual basis. In addition, under Regulation No 1024/2013, the NBB is no longer the competent authority for Belgian banks using an internal model and could not deploy measures under Articles 103 and 104 of the CRD. In addition, the NBB observes that the current SREP decisions do not include any macroprudential capital surcharge for residential real estate risks. The NBB also notes that the use of Articles 103 and 104 is less transparent, as Pillar 2 measures are currently not publicly disclosed. There is, in addition, a point regarding the scope of the measure, since while the risk weight add-on applies to both the outstanding stock of mortgages and the flow of new loans, a Pillar 2 capital requirement would apply only to the outstanding stock, taking into account that Pillar 2 decisions are only taken once a year. Increasing the required Pillar 2 Common Equity Tier 1 (CET1) ratio in order to reflect the amount of capital needed to cover the new measure on mortgage loans will also affect the capital requirements related to credits and exposures other than mortgage loans. This is not in line with the aim of the measure, which is to target only mortgage loans.
- The NBB notes that Articles 101 and 102 of the CRD would not be applicable as the banks using IRB models comply with all the requirements of the CRR and there is no evidence of a breach of this Regulation. A review of internal models carried out by the NBB has not revealed generalised problems relating to the outcomes of internal models, confirming that the low risk weights are simply the result of historical data not incorporating any major property crisis in Belgium. In addition, the risk weight add-on is implemented for the mitigation of a macroprudential risk stemming from adverse developments in the real estate market and increasing borrowers' vulnerabilities, and not in order to correct a microprudential issue of potential miscalibration of internal models. While risk weights should correctly reflect (microprudential) risks, recalibrating the models is neither an adequate nor a sufficient response to identified macroprudential risks, in the opinion of the NBB.
- As regards Article 133 of the CRD, the NBB notes that the increase in the risk weight for residential mortgage loans is proposed to limit the risk of a potential cyclical downturn in the residential real estate market and not structural risks as the systemic risk buffer would do. In addition, the systemic risk buffer cannot be applied to specific asset classes. Similarly, the countercyclical buffer as per Article 136 of the CRD applies to all exposures located in a jurisdiction and, thus, would not achieve the objective of the proposed measure.

Assessment and conclusions

The main argument given in the notification is that, while developments in the Belgian property market (particularly the increase in real estate prices along with high LTV levels and rising indebtedness of the household sector) continue to be a source of concern, risk weights for

exposures towards residential mortgages may not sufficiently reflect credit losses that may occur in the envisaged scenario. Moreover, the proposed measure tries to address the high proportion of riskier mortgage loans extended by IRB banks in Belgium in the context of intensifying household credit risk-taking, by targeting more explicitly the riskier segments and discouraging this type of mortgage loan.

The EBA acknowledges, in line with the ESRB warning on the vulnerabilities of the residential real estate sector, that the increase in house prices and debt levels in combination can pose a threat to the financial stability of banks in Belgium and it does not object to the deployment of macroprudential measures. Based on the feedback received from the other EU competent authorities, the potential of the proposed measure to have a negative impact on the Single Market seems limited.

However, some general observations are made:

- The use of an add-on and additional LGD floors linked to the concept of indexed LTV adds further complexity to the determination of capital requirements and can reduce the transparency of risk weights for market participants. This issue arises because, although the notification states that the macroprudential measure results in a capital buffer, the risk weight add-on as well as the LGD floors affect Pillar 1 requirements and cannot be differentiated from other factors contributing to Pillar 1 requirements by all market participants (other than the banks targeted by the measure). It should be noted that the reduced transparency would also apply to Article 164 (and for any other macroprudential measure) applied to exposure amounts that are not public (in this case, exposures to high LTV loans).
- The NBB reports that the calibration aims to increase banks' capital requirements sufficiently to maintain the loss absorption capacity of the banking sector, and it does so through the use of a stress test model. The NBB's stress test scenarios revealed that additional capital would be needed to absorb potential losses in the event of severe stress. The two components of the measure were then calibrated so as to cover the identified capital shortfall: in a first step, the five percentage points risk weight add-on covers part of the shortfall; in a second step, the LGD floor levels for loans with an indexed LTV exceeding 80% and 90% were calibrated to generate an additional capital buffer that would cover the remaining shortfall. The expected impact of the measure amounts to 87–111% of the simulated shortfall, depending on the scenario considered. Nevertheless, it is not entirely clear from the notification received how the levels of proposed LGD floors were calibrated in detail.
- An assessment of credit losses under stress scenarios for the real estate market is used as a means of calibration for the measure. The use of severe stress scenarios with increases in banks' PD and LGD to account for the capacity of the capital buffers to absorb potential losses in the event of severe stress is undertaken without reference to the EU-wide stress test scenarios or other supervisory stress tests. It is, therefore, unclear from the

notification how residential real estate risks are already indirectly covered in capital requirements and Pillar 2 guidance for Belgian banks via stress tests such as the EU-wide stress test. For example, the EU-wide stress test in 2016 included a fall in house prices in the underlying scenario, and banks were measured against the impact in terms of Pillar 1 capital requirements. As already stated in the EBA Report on practices regarding macroprudential measures,⁶ the use of stress tests to change risk weights can in certain situations lead to a double-counting of risks – which might or might not be intended by the relevant authority.

In addition, some issues raised in the EBA Opinions of 30 April 2014 and 19 February 2016 remain valid:

- The EBA is still of the opinion that an additive adjustment of risk weights as proposed can have a distorting effect, since it would reduce the incentive to estimate conservative risk parameters. This is partly alleviated by the introduction of LGD floors based on LTV buckets. However, the CRR already includes the possibility to increase the LGD exposure-weighted average floor in Article 164. Here it is noted that Article 164 accounts for the possibility of adjusting the exposure-weighted average floor taking into account forward-looking immovable property market developments and is not limited to purely microprudential use. Moreover, it is unclear why the measure proposed by the NBB would have less impact on banks' internal model or the calculation of expected loss amounts pursuant to Articles 158 and 159 of the CRR. In particular, it should be noted that because of the way the risk weight increase is implemented, inconsistent parameters are used as inputs to determine capital requirements (i.e. regulatory EL is not calculated based on the proposed LGD floors). The EBA is of the opinion that the proposed implementation of the measure will lead to inconsistent parameters being used within the Pillar 1 framework. In particular, under Article 158(1) of the CRR, the calculation of expected loss amounts shall be based on the same input figures of PD, LGD and the exposure value for each exposure as used for the calculation of risk-weighted exposure amounts in accordance with Article 151. It should be noted that the LGD is also an input in the calculation of risk weights for defaulted exposures under Advanced IRB (A-IRB).
- The NBB states that it evaluated the adequacy of the calibration of the PD and LGD models used in the regulatory capital calculation within the IRB approach. On average, no major weaknesses were observed so that Article 101 of the CRD would not be applicable. However, the notification implies that risk weights for Belgian IRB institutions are seen as too low, in particular for high LTV buckets. The EBA therefore continues to believe that the issue underlying the macroprudential measure could at least partly and in the longer term be addressed by making changes to banks' IRB models. The recent EBA report on results from the 2016 High Default Portfolios (HDP) exercise shows that IRB banks in Belgium have low default and loss rates for residential mortgages compared with the aggregate EU

⁶ EBA Report on the range of practices regarding macroprudential policy measures communicated to the EBA – July 2015.

level, which combines with levels of LGD and PD and according risk weights below the EU average. The table below shows default and loss rates for residential mortgage exposures towards Belgian counterparties for all EU banks and compares them with the levels for all EU counterparties. Relatively low levels can be observed between the first quartile and the median of all EU banks on a consolidated level.

		5-year default rate	5-year loss rate
EU residential mortgages towards Belgian counterparties	Average	0.5%	3.9%
	Average	1.7%	10.1%
EU residential mortgages towards all counterparties	1st quartile	0.4%	3.6%
	Median	0.9%	7.4%
	3rd quartile	1.6%	14.3%

- Regarding the use of Articles 102, 103 and 104 of the CRD, the NBB refers to the role of the European Central Bank (ECB) as the competent authority for a Belgian Significant Institution using an internal model. As stated in Article 458 of the CRR, Member States shall refer to the designated competent authority, which may apply the SREP if necessary. A reasoning solely based on governance matters, when taken in accordance with Article 458, shall not be taken as sufficient justification. In addition, the EBA believes that Pillar 2, if clearly communicated and disclosed, can also have an effect on the flow of new loans and not just on the stock and target mortgage exposures, as well as a signalling effect to the market. While it is correct that the use of Pillar 2 would reduce the impact of any other capital buffer, this could be seen as a positive separation of capital requirements for different purposes. Nevertheless, although the NBB argues that the ECB does not apply Pillar 2 in a macroprudential way, the EBA stresses that there exists an EU-wide stress test that includes projections of credit losses on banks' domestic mortgage portfolios and an adverse scenario projecting severe declines in house prices. This existing exercise target risks similar to those covered by the proposed measure, regardless of the prudential framework applied.
- The EBA agrees with the NBB that cyclical risks should be addressed with countercyclical and temporary measures as opposed to more structural measures such as the systemic risk buffer. Given the cyclical and portfolio-specific nature of the proposed measure, it is of utmost importance, as argued by the NBB, that the NBB continues to monitor the developments in the property market and to re-assess the rationale of such measures over time.



Done at London, 14 March 2017

[signed]

Andrea Enria

Chairperson

For the Board of Supervisors