Template for notifying intended measures to be taken under Article 458 of the Capital Requirements Regulation (CRR)

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1. Notifying national authority and scope of the notification	
1.1 Name of the notifying authority	Eesti Pank
1.2 Categorisation of measures	The measure is applied in accordance with Article 458(2)(d)(iv) of Regulation (EU) No 575/2013.
1.3 Request to extend the period of application of existing measures for one additional year **(Article 458(9) of the CRR)**	The existing measure will be extended for two additional years.
1.4 Notification of measures to which Article 458(10) of the CRR applies ('notification only procedure')	Not applicable.
2. Description of the measure	
2.1 Draft national measures **(Article 458(2)(d) of the CRR)**	The proposed measure is an extension of credit institution specific minimum level of 15% for the exposure-weighted average of the risk weights applied to the portfolio of retail exposures secured by mortgages on immovable property to obligors residing in Estonia. The measure applies to credit institutions that use the IRB Approach for calculating regulatory capital requirements.
2.2 Scope of the measure **(Article 458(2)(d) of the CRR)**	The scope of the measure will remain unchanged from the existing measure that has been in place since 30.09.2019. The details are as follows: • The measure applies to retail exposures secured by mortgages on immovable property to obligors residing in Estonia.

Date of template version: 2016-03-01

	The calculation of the average risk weight at the portfolio level is based on reported data in the COREP template C 09.02 – Geographical breakdown of exposures by residence of the obligor: IRB exposures (CR GB 2), Estonia, and the relevant cells are: row 070, and columns 105 and 125. • The measure applies to credit institutions that have adopted the IRB Approach. The measure applies on an individual and consolidated basis. Currently there are two IRB banks operating in Estonia with an aggregate market share of 75% in mortgage loan stock.
2.3 Calibration of the measure	The calibration of the proposed measure will be unchanged from the existing measure. The minimum level of the average risk weight for residential mortgage loans will remain at 15%. The calibration of the measure in 2019 was based on an assessment of credit losses from mortgage loans under a stress scenario. In view of the macroeconomic and financial developments after the adoption of the measure, the calibrated floor level at 15% is assessed to remain appropriate.
2.4 Suitability, effectiveness and proportionality of the measure **(Article 458(2)(e) of the CRR)**	The measure is aimed to safeguard the resilience of banks against the systemic risks stemming from lending for residential real estate. High and growing exposure to residential real estate risks by Estonian households and banks is a source of key vulnerabilities for financial stability in Estonia. The risks from lending for residential real estate have not diminished in recent years while the average model-based risk weight of IRB banks for residential mortgage loans has been declining. The intention in setting an average risk weight floor is to ensure that the banks hold sufficient own funds to cover systemic risks related to mortgage loans and the residential real estate market. The measure is effective in addressing the macroprudential concerns by pre-emptively limiting any further decrease in risk weights. To address the macroprudential concerns in Estonia a floor-type measure is more suitable than an alternative set-up based on risk weight add-ons, as the measure is designed so as to avoid any further decrease of the risk weights. The 15% floor applies for the exposure-weighted average of the risk weights applied to the portfolio of mortgage exposures. This means that the IRB banks still have sufficient flexibility to apply lower risk weights to suit the risk profiles of individual loans. The measure is proportional, as it is targeted to mortgage exposures of IRB banks. Risk weight floor increased the aggregate risk exposure of the IRB banks by 160 million euros or 2.2% as of 31 December 2020. The estimated impact on the weighted average CET1 ratio of the IRB banks was approximately -0.8 percentage points. Since all Estonian IRB banks hold capital buffers well above the required level as their weighted average CET1 ratio was 35.7% at the end of 2020, none of the banks has needed to raise new capital to meet the additional capital requirement. Leverage ratio requirement will come into force in June 2021, but is not expected to result in additional capital need, given the high level of management buffers. The average risk weight varies between the banks and the 15% risk weight floor would increase the total risk exposure amount for one bank. However, the implementation of the initial measure in 2019 has had no effect on loan

	margins. The direct negative spillovers from the measure are limited as it applies only to retail exposures secured by real estate property. Hence the measure does not substantially affect the other activities of banks, such as corporate financing. The impact of the measure on lending activity and economic growth has been negligible and the extension of the measure is not expected to have additional impact (see also section 5 on cross-border and cross-sectoral impact of the measure).
2.5 Other relevant information	From March 2015 three requirements have applied for credit institutions when they issue housing loans: an LTV limit of 85%, a DSTI limit of 50%, and a maximum maturity for housing loans of 30 years. O-SII buffer requirements apply to systemically important credit institutions. The two IRB banks are both subject to an O-SII buffer requirement of 2%. Eesti Pank reduced the systemic risk buffer from 1% to 0% in May 2020, to provide leeway for banks to cover possible loan losses and ensure continued lending to real economy.
3. Timing of the measure	
3.1 Timing of the Decision	18 May 2021
3.2 Timing of the Publication	Q3 2021
3.3 Disclosure	The decree of the Governor of Eesti Pank is published in Riigi Teataja, which is the official gazette of the Republic of Estonia (https://www.riigiteataja.ee/en/eli/504092019002/consolide). The decision to extend the measure together with the underlying analysis will be published on the Eesti Pank website.
3.4 Timing of Application (Article 458(4) of the CRR)	Q3 2021
3.5 Phasing in	No phasing-in is planned, as the existing measure will be extended.
3.6 Term of the measure **(Article 458(4) of the CRR)**	The existing measure will be extended for two additional years.

3.7 Review **(Article 458(9) of the CRR)**	The measure will be reviewed again within two years after extension, taking into account the developments of the systemic risk and possible changes in other macroprudential measures.
4. Reason for the activation of the stricter national measure	
4.1 Description of the macro-prudential or systemic risk in the financial system **(Article 458(2)(a) of the CRR)**	During the last four years, the housing loan growth in Estonia has been persistently around 7%, substantially higher than the average growth in the euro area. The COVID-19 crisis had only a temporary effect - the lending activity dropped sharply in spring 2020, but rebounded already during the second half of year and the growth in new lending reached 14% y-o-y in Q4 and accelerated further in early 2021. The quick rebound was supported by the fact that crisis impact has so far concentrated in some labour-intensive sectors, pent-up demand caused by postponed transactions amid Covid-related uncertainty, marked increase in household deposits and by the outlook of continued low interest rates. Based on the latest forecast, Eesti Pank expects the housing loan growth to stay strong at close to 7% in the next few years. The rapid growth of housing loans has fuelled household indebtedness. Despite the rapid growth in household debt during the previous years, it was generally in line with the similarly robust growth in the GDP and disposable income. However, the mortgage loan growth in 2020 exceeded significantly both the GDP growth and household income growth. As a result, household debt to GDP increased 3 percentage points in 2020, reaching 41% and the debt to disposable income ratio grew 4 percentage points to 72%. Accelerated growth of indebtedness increases the risks to household debt sustainability and loan servicing capacity. The level of household indebtedness in Estonia is lower than in most other EU countries. However, as the incomes and financial buffers of Estonian households are lower than the EU average, the vulnerabilities associated with faster growth of indebtedness could be comparatively higher. Housing price growth in Estonia slowed to around 4% y-o-y during spring 2020 and accelerated to 5% in second half of the year. From 2021, the demand in housing market has further increased, leading to upward pressure on prices. The recent growth has been supported by increased share of transactions with new apartments, in combination with somewhat lower supply, at least in short-term, owing to the heightened uncertainty in the first half of 2020. In addition, changes in the second pillar of the pension system have prompted households to take sizeable funds out from the pension system in the second half of the year, which may fuel further increase in activity and prices, when directed to real estate market. According to the Eesti Pank econometric model for measuring overvaluation in the housing market, likelihood that housing prices on average are slightly overvalued has increased, compared to 2018. The exposure of the Estonian banking sector to residential real estate risks is high. In 2020, housing loans accounted for 43% of the real sector loan and leasing portfolio, compared to 41% in 2018. Banks are the main providers of housing loans in Estonia while the banking sector in Estonia is also highly concentrated and a few large players dominate the market. At the end of 2020 the share of the two IRB banks was 75% of the total

	housing loan market and their share in new housing loans was 70%. This reflects the crucial role played by the IRB banks in the supply of housing loans to households. While the macroprudential concerns are increasing, the trend of declining average model-implied risk weights of the IRB banks has continued, reflecting favourable economic conditions of recent years and low interest rates that have bolstered loan quality. The impact of the COVID-19 crisis has not yet manifested in loan quality, owing to substantial public sector support measures and loan payment moratoria agreed between banks. This decline in model-implied risk weights indicates a growing risk that the resilience of the banking system to systemic risks related to mortgage loan growth and residential real estate would be eroding, if the current risk weight floor measure were not applied. Eesti Pank as the macroprudential authority decided to introduce the risk weight floor in 2019 to ensure that banks with substantial market share and exposure to the mortgage loan market as a whole maintain their resilience to the related systemic risks. Compared to 2018, the pre-floor exposure-weighted average risk weight of the IRB banks on retail exposures in Estonia secured by immovable property has declined from 13.4% to 12.8% at the end of 2020. The application of the floor helped to raise the exposure-weighted average risk weight of the IRB banks to 15.3%. Given the discrepancy between the elevated level of systemic risks related to residential real estate and the continuing decrease in risk weights, the continuation of the measure appears necessary. Estonia's past experience from 2008-2009 has shown that a deterioration in the economic environment can lead to significant debt servicing problems for households and that the need for credit institutions to make additional provisions for NPLs can increase very rapidly. Given the high level of exposure of Estonian banks to mortgages and the high share of the systemically important IRB banks in the lending, the materialisation of any negative scenarios would have a significant impact on the Estonian economy and the financial sector.
4.2 Analysis of the serious negative consequences or threat to financial stability **(Article 458(2)(b) of the CRR)**	Residential mortgage loans make up a large share of the total exposure of the Estonian banking sector. This means that the declining risk weights could lead to insufficient capital being held against the systemic risks related to lending for residential real estate. If systemic risks were to materialise, the capital buffers of the banks may be insufficient to withstand the potentially large loan losses that could follow a severe downturn in the real economy or in the real estate market. Given the high degree of dependence of households and NFCs on financing by banks and the high level of concentration of the banking sector, it is essential that the capital buffers be sufficient to ensure the functioning of the financial system and a smooth supply of credit to productive sectors also under negative macroeconomic scenarios.
4.3 Indicators prompting use of the measure	The main indicators are: • Housing loan growth and household indebtedness • Housing prices and indicators for price valuation

	• The model-implied risk weights of retail exposures secured by mortgages on immovable property • The share of housing loans in the total lending and in the total assets of the banking sector • Concentration in the housing loan market and the share of the IRB banks' exposures
4.4 Justification why the stricter national measure is necessary **(Article 458(2)(c) of the CRR)**	The risk weights for mortgage loans calculated using internal models have declined reflecting favourable macroeconomic conditions over the past years. Compared to the time of initial implementation of the risk weight floor in 2019, the average model-implied risk weight has declined slightly further. However, looking forward, the level of systemic risks arising from the macroeconomic environment and from mortgage lending in particular remain elevated. The aim of the proposed measure is to safeguard the banking sector from the systemic risks that are related to residential mortgage loans. The large market share of the IRB banks makes it especially important that they be sufficiently capitalised to withstand the impact of the negative economic scenario and worsening of loan servicing ability of borrowers. Eesti Pank is of a view that under these circumstances, extension of the measure is necessary. **Article 124 of Regulation (EU) No 575/2013** allows the relevant authorities to set higher risk weights for exposures secured by mortgages on immovable property where the standardised approach is used for calculating the own funds requirements for credit risk. Article 124 does not apply to banks using the IRB approach. **Article 164 of Regulation (EU) No 575/2013** allows the relevant authorities to set a higher minimum level for the exposure-weighted average loss given default (LGD) rates for retail exposures secured by mortgages on residential property. The underlying cause for Eesti Pank increasing the risk weights is not related to the dynamics of LGD values. Rather, a favourable macroeconomic environment and low interest rates have led to more favourable credit risk characteristics, and have helped to lower default rates and consequently led to lower PD values. The PD values have continued on a downward trend since implementation of the risk weight floor. Increasing the minimum LGD level by applying Article 164 would be less transparent and have only a limited effect on risk weights. **Under Article 133 of Directive 2013/36/EU**, each Member State may introduce a systemic risk buffer of Common Equity Tier 1 capital for the financial sector, or for one or more subsets of that sector, in order to prevent and mitigate macroprudential or systemic risks not covered by Regulation (EU) No 575/2013, in the meaning of a risk of disruption in the financial system with the potential to have serious negative consequences to the financial system and the real economy in a specific Member State. The systemic risk buffer can also be applied to sectoral exposures defined in Article 133 (5)(b) or subsets of these exposures. The aim of the risk weight floor, that has been in place from 2019, is to safeguard the sufficiency of the capitalisation of the banks using internal risk models against risks stemming from domestic mortgage loans. Applying a systemic risk buffer would have an impact on all exposures, including, for

	example, credit to the corporate sector and SMEs. Therefore, such measure would have sizeable side effects and would not achieve the desired impact of limiting risks related to residential mortgage loans. The systemic risk buffer applied only to retail exposures secured by residential property would not be efficient in achieving the desired outcome of establishing a floor to prevent further decline in risk weights. The sectoral buffer requirement would not act as a floor and would have to be set at a relatively high level to achieve the equivalent impact to existing measure, affecting disproportionately those banks that are using a more conservative risk assessment. In addition, Eesti Pank considers that in the current highly uncertain environment, extending the already existing measure is preferable to changing the policy framework and introducing a new capital buffer requirement. **Under Article 136 of Directive 2013/36/EU** the designated authority can set the countercyclical buffer rate. The purpose of the countercyclical buffer is to mitigate the risks arising from excessive credit growth in a Member State and it is guided by the deviation of the credit-to-GDP ratio from its long-term trend. As the countercyclical buffer rate is applied as a percentage of the total risk exposure amount calculated in accordance with Article 92(3) of Regulation (EU) No 575/2013, it is not a suitable instrument for addressing risks related to only a subset of exposures such as mortgage loans.
5. Cross-border and cross-sector impact of the measure	
5.1 Assessment of cross-border effects and the likely impact on the internal market **(Article 458(2)(f) of the CRR and Recommendation ESRB/2015/2)**	The risk weight floor is to be applied on the basis of the exposure-weighted average risk weight of Estonian retail exposures secured by mortgages on immovable property. At more than 99%, the vast majority of the retail loans secured by mortgages held by the IRB banks have been issued in Estonia. Besides, the average applicable risk weight on mortgage loans of banks in other countries in the region is generally higher, thus disincentivising banks to shift the mortgage exposures from Estonia to other countries. Therefore the likelihood of any direct impact on other Member States is small.
5.2 Assessment of leakages and regulatory arbitrage within the notifying Member State	Residential mortgage loans in Estonia are predominantly issued by credit institutions. The share of non-bank mortgage lending is very small. The current capital buffers of credit institutions that would be subject to the intended measure are sufficient to allow them to meet the requirement without needing to raise additional capital. The current levels of the voluntary capital buffers mean that extending the measure should not limit or significantly influence the lending by credit institutions to other economic sectors.
5.3 Reciprocation by other Member States **(Article 458(8) of the CRR and Recommendation ESRB/2015/2)**	The proposed measure would apply to credit institutions licensed in Estonia. It would not apply to banks providing credit in Estonia through branches or as direct cross border lending. As of end 2020, nine credit institutions and five branches of foreign credit institutions were licensed to operate in the Estonian market. The two credit institutions that use internal model approaches for credit risk assessment held about 75% of housing loans, while branches of foreign credit

	institutions held only around 1% of all outstanding housing loans. The provision of direct cross-border mortgage lending is currently very limited. Because of the limited activity and market share of the foreign branches in the Estonian mortgage market, Eesti Pank has decided not to ask for reciprocity for the proposed measure. Eesti Pank will follow developments closely and may reconsider the need for reciprocity should the share of residential mortgage loans issued by branches increase considerably.
6. Miscellaneous	
6.1 Contact person(s) at notifying authority	Jaak Tõrs, Head of Financial Stability Department +372 6680 905 jaak.tors@eestipank.ee
6.2 Any other relevant information	