ESRB
European Systemic Risk Board
European System of Financial Supervision

Assessment of the Estonian 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 2 May 2023 Eesti Pank notified the European Systemic Risk Board (ESRB) of its intention to extend, for a second time, the application of a stricter national measure concerning risk weights under Article 458(2)(d)(iv) of the Capital Requirements Regulation (CRR),[1] in accordance with Article 458(9) of the CRR. Eesti Pank is the designated authority in charge of applying Article 458 of the CRR in Estonia.[2] The draft measure is a continuation of the 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 internal ratings-based (IRB) approach for calculating regulatory capital requirements.

Pursuant to Article 458(4) in conjunction with Article 458(9) of the CRR, the ESRB must provide the Council, the European Commission and Estonia 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 procedural framework for providing opinions under Article 458 of the CRR is clarified in Decision ESRB/2015/4[3].

The ESRB's assessment focuses on the net benefits of the national measure for maintaining financial stability. In particular, the ESRB has assessed the rationale and merit of the measure against the criteria below.

- **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 (CRD)[4] and the CRR adequately and appropriately address the risk, taking into account their relative effectiveness?
- **Effectiveness**: Is the measure likely to achieve its intended objective?

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1 See Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

2 According to Eesti Pank Act § 241(6), Eesti Pank has the power to take measures related to Article 458 of the CRR.

3 See Decision of the European Systemic Risk Board of 4 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 (ESRB/2015/4), as amended by Decision ESRB/2021/7.

4 See 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, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27 June 2013, p. 338).

- **Efficiency and suitability**: Will the measure achieve its objective in a cost-efficient way, i.e. are both the instrument and the calibration appropriate?
- **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 on the information provided by, and discussions with, Eesti Pank and its staff.

Section 1: Description and background of the measure

1.1 Description of the measure

The existing measure consists of a 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 exposures are referred to in this assessment as "Estonian mortgage loans". The measure is intended to support the resilience of credit institutions and to ensure that they hold sufficient own funds to cover systemic risks related to mortgage loans and the residential real estate (RRE) market.

The measure applies to credit institutions licensed in Estonia that are authorised to use the IRB approach for calculating regulatory capital requirements for retail exposures ("IRB credit institutions"). The measure applies to these institutions on an individual and consolidated level. At the end of 2022, around 72% of outstanding Estonian housing loans were held by two IRB credit institutions. This would fall under the scope of this measure.

The current measure entered into force on 30 September 2019. Having been extended for a further two years with effect from 30 September 2021, it will remain in place until 29 September 2023. The measure is set to be extended for another two years, meaning it will continue to be in effect from 30 September 2023 until 29 September 2025.

Given the current situation of limited activity and market share of foreign branches in the Estonian mortgage market, Eesti Pank does not intend to request the reciprocation of the extended measure . Branches of foreign institutions hold around 1% of all outstanding housing loans in Estonia, and direct cross-border lending for house purchases is insignificant.

1.2 Background of the measure

The proposed extension of the measure will continue to complement a set of macroprudential instruments that the Estonian authorities already use. The other macroprudential policy tools currently being used are set out below.[5]

- Borrower-based measures applicable since March 2015 to new housing loans: a loan-to-value (LTV) limit of 85%, a debt-service-to-income (DSTI) limit of 50%, and a maximum maturity for housing loans of 30 years.
- An other systemically important institution buffer of 2% applicable to four credit institutions, including the two IRB credit institutions.
- A countercyclical buffer (CCyB) base requirement of 1%. In the light of cyclical risks, Eesti Pank has decided to increase the CCyB rate by 0.5% from 1 December 2023, which will result in an applicable CCyB rate of 1.5%.

According to Eesti Pank, the proposed extension of the measure aims to safeguard the resilience of credit institutions against systemic risk stemming from residential real estate lending. It would ensure credit institutions hold sufficient capital against existing systemic risk and prevent risk weights from further declining. Additionally, it could also help to address vulnerabilities in the RRE market and ensure that macroprudential buffers remain effective. If the risk weights were to decline further, the capital set aside for macroprudential capital requirements would decline in nominal terms, because they are calculated on the basis of risk-weighted assets.

Section 2: Analysis of the underlying systemic risks

During the 2022 ESRB assessment of vulnerabilities in the RRE sectors of the European Economic Area countries, the ESRB identified Estonia as having medium vulnerabilities related to RRE markets. The key vulnerabilities identified were house price overvaluation, high house price growth, high (mortgage) credit growth and high growth in household indebtedness.[6] At the time, the ESRB deemed the macroprudential policy with regard to RRE risks, including the Article 458(2)(d)(iv) of the CRR measure, was appropriate and sufficient as long as the upside risks to the RRE market remain contained.

Nominal annual house price growth continued to accelerate in 2022 and while the growth moderated in the beginning of 2023, there are expectations for high growth to resume in the future. Demand in the housing market in Estonia remained strong in the first half of 2022 owing to a rise in the average wage, accumulated savings and the money withdrawn from second pillar pension funds. The strong demand, combined with the lack of supply to the market, resulted in house prices rising quickly. Yearly growth in the price index for housing rose to 27% by

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[5] See **Financial Stability Review**, Eesti Pank, p. 15, November 2022.

[6] See report "**Vulnerabilities in the residential real estate sectors of the EEA countries**", ESRB, February 2022.

the end of the second quarter of 2022 according to Statistics Estonia.[7] This moderated somewhat at the end of 2022 (to 17% in the fourth quarter of 2022) and the beginning of 2023. According to Eesti Pank, housing loan growth in Estonia has remained almost three times higher than the euro area average, and it is expected to remain strong around 6-7% in the coming years. Furthermore, estimates point to house prices being on average 10-15% overvalued in 2022.

The debt servicing capacity of Estonian households has been negatively affected by increased house prices and interest rate hikes. The rapid growth of house prices has increased household debt servicing costs, as larger loans compared with income are required. Furthermore, the majority of housing loans in Estonia have variable interest rates. Higher interest rates therefore pass through to borrowers quickly, thus impacting the debt servicing capacity. High inflation could, if sustained over a longer period and not compensated by an increase in income, put pressure on the ability of households to service their loans, with lower income households being the first to bear the brunt of this pressure. Although average monthly gross incomes have risen fast since 2020, high inflation reduced the purchasing power of wage earners by the mid-2022.[8] Against the backdrop of slowing economic growth, quick loan growth results in mounting systemic risks, as households have to cope with higher loan servicing costs. If the economic situation were to deteriorate unexpectedly, the risk of borrower's ability to repay could result in a rapid increase in the need for credit institutions to make additional provisions for non-performing loans.

The Estonian banking sector remained highly concentrated, with a few large players dominating the market, and banks acting as the main providers of housing loans. At the end of 2022, the share of the two IRB credit institutions was 72% of the total housing loan market, and 64% of new housing loans. This reflects the crucial role played by the IRB credit institutions in supplying housing loans to households. During 2022, the pre-floor exposure-weighted average risk weight of the IRB credit institutions on Estonian mortgage loans stabilised at 14.9%. However, the aggregate number masks heterogeneity in the risk weights of the respective credit institutions, as one bank's risk weights was far below the average.

Section 3: Effectiveness and efficiency of the measure

3.1 How the measure addresses the identified risk

The proposed extension of the measure would complement a wider set of initiatives that have been introduced over several years to address risks in the Estonian banking sector and the RRE sector. In

[7] See **Financial Stability Review**, Eesti Pank, Figure 23, May 2021.

[8] See **Financial Stability Review**, Eesti Pank, November 2022.

addition to the current measure, which was introduced in 2019 and extended in 2021, since March 2015 Eesti Pank has enforced three borrower-based requirements that credit institutions must apply to mortgage loans.

According to Eesti Pank, the primary objective of the proposed extension of the existing measure is to counteract and prevent a potential further decline in risk weights applied by IRB credit institutions to the Estonian mortgage loan portfolio. This provides a macroprudential backstop, which in Eesti Pank's view will protect the resilience of IRB credit institutions against systemic risks related to mortgage loans and the RRE market. According to the authorities, the pre-floor exposure-weighted average risk weight of the two current IRB credit institutions on retail exposures in Estonia secured by immovable property stabilised at 14.9% in 2022, but at the same time the divergence of model-based risk weights among the IRB credit institutions increased. This points to Article 458 of the CRR measure, which is currently affecting one of the IRB credit institutions. The measure also provides a signal as to the risks in the real estate market, and takes a forward-looking approach by preventing risk weights from decreasing further. Otherwise, risk weights for exposures to residential mortgages may not sufficiently reflect the potential credit losses that could occur in the event of a sudden economic downturn.

The measure is to be extended using an unchanged calibration. Eesti Pank based the calibration on an assessment of credit losses stemming from Estonian mortgage loans under a stress scenario. This scenario assumes a macroeconomic shock similar to that which affected Estonia in 2008-09 in the context of the global financial crisis. The shock corresponds to a cumulative decline in real GDP of 20%, a decrease in house prices of 50% and an increase in the unemployment rate to 20%. Given the macroeconomic and financial developments after the adoption of the current measure, Eesti Pank considers it appropriate to set the minimum level of the exposure-weighted average risk weight for residential mortgage loans at 15%.

The ESRB is of the view that while the measure affects only a limited number of credit institutions, these credit institutions have a large market share. Ensuring their resilience to risks from mortgage lending is therefore of the utmost importance in Estonia. Furthermore, from a forward-looking perspective, the measure prevents a further decline in risk weights for the RRE portfolio, thus acting as a backstop.

3.2 How the measure relates to possible alternatives

a) Increasing the risk weights for credit institutions applying the standardised approach to credit risk (Article 124 of the CRR)

Article 124 of the CRR would not be effective in meeting the measure's objectives, given that the vast majority of the Estonian mortgage market exposures are held by IRB credit institutions. Furthermore, the risk weight of 35% under the standardised approach is considered sufficient compared with the proposed risk weight floor of 15% for IRB credit institutions.

b) Increasing exposure-weighted average loss given default (LGD) for all retail exposures secured by residential property for credit institutions applying the IRB approach to credit risk (Article 164 of the CRR)

According to Eesti Pank, the lower risk weights for mortgage loans have been the result of a fall in the probability of default (PD) rather than in the LGD estimates. In fact, a favourable macroeconomic environment and low interest rates over the last decade have led to more favourable credit risk characteristics and lower PD values. The ESRB is of the view that given the narrower focus of Article 164 of the CRR, i.e. it only targeting the LGD and not the PD, any measure under Article 164 of the CRR would not sufficiently achieve the intended purpose of the 15% risk-weight floor.

c) Using the systemic risk buffer (Article 133 of the CRD)

Member States may introduce a systemic risk buffer (SyRB) to prevent and mitigate systemic or macroprudential risks not covered by the CRR or Articles 130 and 131 of the CRD. The SyRB can be applied to all credit institutions or to a subset of credit institutions. Furthermore, the SyRB can be applied to all, sectoral or subsets of sectoral domestic exposures, exposures in third countries and all or sectoral exposures in other Member States.

Applying a sectoral SyRB could achieve a similar degree of resilience and increased transparency; however, substantial negative side effects could arise. The aim of the risk weight floor is to safeguard the sufficiency of the capitalisation of the credit institutions using internal risk models against risks stemming from domestic mortgage loans. Using a SyRB applicable to all or all domestic exposures would have sizeable side effects, affecting all exposures including credit to the corporate sector and small and medium-sized enterprises, and it would not achieve the desired goal of limiting risks related to residential mortgage loans. A sectoral SyRB applied solely to retail exposures secured by residential immovable property would not be as efficient in achieving the desired outcome of establishing a floor to prevent a further decline in risk weights. It would need to be set at a relatively high level to achieve the equivalent impact of the existing measure, and it would additionally affect, disproportionately, those credit institutions that employ a more conservative risk assessment and already apply comparatively higher risk weights. It is already observed that the heterogeneity in credit institution risk weights is high, which means that a sectoral SyRB would have very different impacts on capital requirements of individual credit institutions in nominal terms. Also, the sectoral SyRB rate would have to be regularly recalibrated (potentially substantially) to reflect the evolution of risk weights of individual credit institutions. The ESRB concurs with Eesti Pank that at this stage, extending the already existing measure is preferable to applying a sectoral SyRB, also taking into consideration the forthcoming implementation of the revised Basel requirements, including the output floor.

d) Using the countercyclical capital buffer (Article 136 of the CRD)

Eesti Pank considers that the CCyB is not an appropriate tool to address sectoral systemic risk, as it would apply to all exposures in Estonia and not just to Estonian mortgage loans. The CCyB rate is applied as a percentage of the total amount of risk exposure and therefore cannot be applied to specific subsets of exposures. Addressing the risk via a CCyB would lead to side effects similar to those mentioned above for the SyRB applicable to all exposures or all domestic exposures.

e) Using other measures

Since 1 March 2015, all credit institutions operating in Estonia have had to comply with three requirements when issuing housing loans. These limits are an LTV limit of 85%, a DSTI limit of 50%, and a maximum maturity for housing loans of 30 years.

While borrower-based measures are powerful tools, they only apply to new loans, so they only have an impact on the flow and not on the stock of the RRE portfolio. Therefore, they cannot address the underestimation of risks that could result from very low (and potentially further declining) risk weights related to the stock of RRE exposures. Furthermore, Eesti Pank argues that the borrower-based measures introduced in 2015 were calibrated as a backstop on the basis of credit institutions' actual loan terms and conditions and that there is no evidence of a causal link between these measures and the observed decrease in risks weights.

Section 4: Analysis of the net benefits of the measure

4.1 Effects on financial stability, financial system resilience and economic growth

The proposed extension of the measure is expected to continue contributing to the resilience of the Estonian banking system, therefore possibly enhancing the overall resilience of the economy as a whole, albeit to a modest extent. Eesti Pank estimates the total increase in risk-weighted assets of the IRB credit institutions was €196 million (2.2%) as of 31 December 2022. The weighted average Common Equity Tier (CET1) ratio of the IRB credit institutions would decrease by approximately 0.6 percentage points if the measure is extended. However these numbers mask the existing heterogeneity in risk weights, and the impact on the capital requirements of some credit institutions is greater. Considering the weighted average CET1 ratio for IRB credit institutions was actually 26.6% at the end of 2020, and notwithstanding the different impact on the capital ratios of individual credit institutions, no IRB credit institution is expected to need to deleverage or raise new capital following the extension of the existing measure.

According to Eesti Pank, the extension of the measure will contribute to the resilience of the Estonian banking system, which is key to the proper functioning of the Estonian economy. The Estonian economy is a small open economy that is vulnerable to negative developments in the external environment The private sector is highly dependent on financing from the banking sector, and the banking sector is highly concentrated in the two IRB credit institutions affected by the measure. Therefore, in the view of Eesti Pank, in order to avoid a disruption in the supply of credit to the economy under negative macroeconomic scenarios, it is important to ensure that the capital buffers of IRB credit institutions are sufficient by means of macroprudential backstops that go beyond microprudential measures. In particular, since residential mortgage loans constitute a large share of the total exposure of the Estonian banking sector, if IRB credit institutions were to underestimate the systemic risk related to lending to the RRE market, they may not have sufficient capital buffers to withstand the potentially large loan losses that could result from a severe downturn in the real economy or in the RRE market.

4.2 Effects on both domestic and cross-border lending

Given the sufficient capitalisation of Estonian IRB credit institutions, Eesti Pank expects a limited impact. Eesti Pank also expects that the extension of this measure will not limit or significantly influence lending by credit institutions to other economic sectors. Eesti Pank considers that while the applied risk weight floor is sufficient to mitigate the build-up of risks, it will have a limited impact on the general economy.

With the vast majority of Estonian mortgage retail loans being held by IRB credit institutions, the likelihood of there being any material impact on cross-border lending is small. Eesti Pank estimates that over 99% of Estonian mortgage loans held by IRB credit institutions were originally issued in Estonia. Branches of foreign credit institutions only hold around 1% of all outstanding housing loans, and the provision of direct cross-border mortgage lending is currently very limited. In addition, the average risk weight applicable to mortgage loans for banks in other countries in the region is generally higher, which disincentivises banks to shift mortgage exposures from Estonia to other countries. Therefore, the likelihood of any direct impact on other Member States is small. According to Eesti Pank, the share of non-bank mortgage lending is very small. In addition, no comments pointing towards a negative impact on the Internal Market have been raised by ESRB members.

4.3 Effects on intragroup behaviour of credit institutions

Given that IRB credit institutions already meet the higher capital requirements, it is unlikely that the measure will cause a significant shift of operations within their group structures. Both of the IRB credit institutions in question are subsidiaries of credit institutions residing in the European Union. However, the share of the Estonian subsidiaries in total assets of the whole group is only 5.1% and 2.5%, respectively, according to the banks' 2022 annual reports. Therefore, it is unlikely that the requirements will have any material impact on intragroup behaviour.

The development of cross-border mortgage lending and lending through branches should be monitored, as Eesti Pank does not intend to request reciprocation of the measure. In the absence of reciprocation, credit institutions may turn/resort to intragroup shifts in exposures in order to circumvent the measure. Further analysis of developments at the level of individual institutions (in particular by the supervisory colleges of the banking groups concerned) should be undertaken if there are any significant intragroup activities in Estonian mortgage loans. Finally, it should be noted that in the absence of reciprocity, the higher requirements stemming from the measure would not be reflected in the requirements at the parent level.

Conclusions

According to Eesti Pank, the main purpose of the proposed extension of the measure is to counteract and avoid further decreases in risk weights applied to the IRB credit institutions' portfolios of retail exposures secured by mortgages on immovable property to obligors residing in Estonia. Sufficiently high risk weights should support the resilience of credit institutions and ensure that they hold sufficient own funds to cover the materialisation of systemic risks related to mortgage loans and the RRE market. Eesti Pank also highlighted that while the measure has had an immediate impact on risk weight levels in one particular institution, it has also had a broader, pre-emptive and forward-looking impact overall and is commensurate with its macroprudential purpose.

Systemic risk related to RRE in Estonia has increased over recent years. Some of the key vulnerabilities are house price overvaluation, house price growth, household indebtedness and mortgage lending growth. The number of transactions in the RRE market has increased and prices are expected to grow in the future. Household debt burden has increased and real estate prices are likely to be overvalued. A decrease in risk weights in the relevant IRB institutions could cause a reduction in the resilience to systemic risk.

The ESRB therefore considers that the proposed extension of the measure may help to maintain resilience in IRB credit institutions in Estonia, in doing so mitigating a possible materialisation of systemic risk in the RRE market. While RRE systemic risk in Estonia has increased over recent years, the measure is aimed at ensuring that credit institutions hold sufficient own funds to cover systemic risks should they materialise.

Furthermore, the ESRB is of the view that the alternative macroprudential instruments listed in Article 458 of the CRR would not be appropriate to address the risk at hand. Measures such as those listed under Articles 124 and 164 of the CRR, as well as the systemic risk buffer or the CCyB, are also considered to be inappropriate or insufficiently efficient as they do not provide the intended incentives, are too broad-based, may impact credit institutions in a disproportionate manner or be administratively burdensome to operate. Furthermore, they do not address the relevant type of risk, exposure or credit institution.

Overall, the ESRB is of the opinion that the extension of the measure would not entail disproportionate adverse effects for the internal market or the financial systems of other Member States. The measure would ensure a level of risk weights commensurate with the systemic risk and prevent a further potential decline in risk weights applied by IRB credit institutions to the portfolio of Estonian mortgage loans. Also, as the average applicable risk weight on mortgage loans of credit institutions in other countries in the region is generally higher, this should not have a disproportionate adverse effect on the internal market.