EBA-Op-2022-09

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

Introduction and legal basis

1. On 8 August 2022, the European Banking Authority (EBA) received a notification from the European Systemic Risk Board (ESRB) on the intention of the Central Bank of the Netherlands (De Nederlandsche Bank – DNB), to apply Article 458(9) of Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms.[1] This notification concerns the extension of a measure initially activated by the DNB on 1st January 2022 based on Article 458(2)(d)(iv) of that Regulation, to introduce a minimum average risk weight for the calculation of regulatory capital requirements applicable to exposures to natural persons secured by mortgages on residential property located in the Netherlands and applicable to credit institutions that use the Internal Ratings Based (IRB) approach for calculating regulatory capital requirements.

2. The EBA's competence to deliver an opinion is based on the second subparagraph of Article 458(4) in conjunction with Article 458(9) of Regulation (EU) No 575/2013.

3. In accordance with the second subparagraph of Article 458(4) of the Regulation (EU) No 575/2013, within one month of receiving the notification from the designated or competent authority entrusted with the national application of Article 458 of that Regulation, the EBA is required to provide its opinion on the points referred to in paragraph 2 of such Article 458 to the Council, the European Commission, and the Member State concerned.

4. In accordance with Article 14(2) of the Rules of Procedure of the EBA[2], 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 (OJ L 176, 27.6.2013, p. 1).

[2] Decision of the EBA concerning the Rules of Procedure of the Board of Supervisors of 22 January 2020 (EBA/DC/2020/307).

Background of the measure to be extended

5. The proposed measure under Article 458 of Regulation (EU) No 575/2013 is an extension of the current measure (in place until 30 November 2022) which entails imposing a minimum average risk weight for IRB banks' exposures to natural persons secured by mortgages on residential property located in the Netherlands, for which the IRB approach is used for calculating regulatory capital requirements, and which are not wholly or partly covered by the Dutch National Mortgage Guarantee scheme (NHG). With the extension, the measure will be in force for two additional years, from 1 December 2022 until 30 November 2024.

6. The exposure-weighted average of risk weights, as calculated by the measure, will act as a minimum average risk weight at the portfolio level. For each individual exposure item in scope of the measure, a 12% risk weight is assigned to the portion of the loan not exceeding 55% of the market value of the property that serves as collateral to the loan, and a 45% risk weight is assigned to the remaining portion of the loan. This means the risk weights of the individual loans to be used for this calculation increase with the Loan-To-Value (LTV) ratio of the loans: from 12% for loans with an LTV ratio up to 55% to 26.85% for loans with an LTV ratio of 100%. The continuous approach helps to avoid any distortions due to cliff effects.

7. In its Opinion dated 6 February 2020[3], the EBA did not object to the activation of the measure. The EBA acknowledged the concerns of the DNB on the build-up of risks in the residential real estate sector, the large share of high-LTV loans and household indebtedness, and the low-risk weights for real estate exposures by IRB banks.

8. However, in its Opinion the EBA had some comments regarding the choice of the measure, its calibration, and its impact, including the following observations:

   - The use of the 55% LTV ratio as a threshold to distinguish riskier loans from other is static but the LTV of the exposure is based on the current market value, which will vary over time. This implies that the calibration will be pro-cyclical in nature, due to the direct dependence of the measure on housing price developments. An increase in the risk weight floor and hence in the risk-weighted assets during the downswing phase could pose a risk to the stability of the Dutch banking sector. This seems to be inconsistent with the overall purpose of a macroprudential measure. However, it is difficult to assess the materiality of this pro-cyclicality.

   - In addition, the EBA saw some practical challenges in the reciprocation by other jurisdictions of the intended measures due to the use of an LTV metric based on the current market value of immovable property.[4] Given this, any reporting requirement of the

[3] Opinion of the European Banking Authority on measures in accordance with Article 458 of Regulation (EU) No 575/2013 of 6 February 2020 (EBA/Op/2020/03) available at https://eba.europa.eu/sites/default/documents/files/document_library/Publications/Opinions/2020/EBA-Op-2020-03%20EBA%20Opinion%20on%20measures%20taken%20by%20DNB%20%20in%20accordance%20with%20Art%20458.pdf

[4] The LTV ratio is defined as the outstanding loan amount divided by the market value of the collateral.

measure should be shared with relevant foreign authorities to facilitate reciprocation. Finally, the definition of the LTV metric may differ between the Netherlands and other Member States. This may give rise to comparability issues.

- The DNB reported that the calibration of the original measure was done using a stress test model and by employing the adverse scenario of the 2018 EU-wide stress test. The EBA noted that the use of stress tests to adjust risk weights can, in certain situations, lead to a double counting of risks, which might or might not be intended by the relevant authority. This called for close monitoring of the impact of the proposed measures and its interaction with any Pillar 2 guidance set following the finalisation of the EU-wide stress test.

- The EBA stressed that it is important that the competent authority encouraged IRB banks established in the Netherlands to make the appropriate efforts to develop their internal models and address any potential deficiencies making them appropriate to withstand a severe economic downturn. In addition, the EBA encouraged the DNB to reassess the rationale for the original measure in the light of the outcome of changes introduced in Directive 2013/36/EU[5] by Directive (EU) 2019/878[6], referring such EBA Opinion, in particular, to those related to the systemic risk buffer (SyRB).

Opinion on the extension

Economic rationale for the measure

9. The DNB has notified an extension of the period of application of its earlier decision by two years, starting on 1st December 2022, arguing that the vulnerabilities and systemic risks stemming from Dutch mortgages and the developments in the housing market remain elevated and are intensifying.

10. The DNB argues that systemic risk from the Dutch housing market has substantially increased over the past few years and that some risk indicators have deteriorated further since the introduction of the measure. House prices have gone up sharply over several years in a row and growth rates have been above 15% (year-on-year) since July 2021, with the sharp price growth currently characterising the market in the entire country. The average transaction price has more than doubled since mid-2013, with 80% of houses sold above the asking price and the average transaction period amounting to 23 days. The DNB refers also to the latest ESRB

[5] 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 27.6.2013, p. 338).

[6] Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures (OJ L 150 7.6.2019, p. 253).

assessment report which notes that vulnerabilities have remained elevated in the Netherlands.[7]

11. Furthermore, the DNB assesses that households have shown increasingly risky borrowing behaviour. Loan-To-Income (LTI) ratios of new loans to both first-time buyers and home-movers have gradually increased and the share of new loans with an LTI ratio close to the regulatory limit has increased over the past few years. Although the average LTV ratio for new mortgages has been declining for some time, LTV ratios of new loans remain high, according to the DNB. In addition, the share of new mortgages with NHG coverage has decreased due to the higher residential real estate price level. Moreover, interest-only mortgages have regained popularity with households across all age groups. The large share of interest-only mortgages (around 44% of the outstanding stock) makes Dutch households relatively vulnerable to rising interest rates, although Dutch households tend to fix their interest rates for a relatively long period. At last, the DNB notes that households are facing increased financial pressures due to the current high inflation and higher energy costs.

12. The DNB assesses that banks and households in the Netherlands are particularly vulnerable to a downward correction in the housing market. According to the DNB, banks can be hit by a house price correction both directly and indirectly. Stress tests show that banks' expected mortgage loan losses could surge in an adverse scenario and market participants could be less keen on funding Dutch banks. A housing market correction would also hit Dutch banks indirectly due to the high sensitivity of the Dutch economy to house price shocks, as high indebtedness makes Dutch households vulnerable to a downward correction in the housing market. The negative economic impact would reduce banks' profitability and increase their total risk exposure amount (TREA).

13. According to the DNB, the design of the initial measure will not be altered with the extension. Based on 2021Q4 data, the measure is expected to result in an aggregate increase of total own funds[8] for IRB banks of EUR 4.5 bn, of which more than EUR 3 bn is Common Equity Tier 1 capital. The measure is expected to increase the average risk weight of IRB calculated mortgage exposures to around 14%. The DNB assesses that this increase in the total own funds is above the increase needed to ensure a minimum level of resilience. Before the introduction of the measure, the DNB performed several analyses to assess the potential impact of a severe housing market correction on banks. The DNB ran a top-down stress test which used the adverse scenario from the 2018 EU-wide stress test. The DNB found that the average risk weight for mortgage loans could increase by more than what was estimated based on constrained bottom-up calculations. The DNB concluded that the potential increase in the average risk weight found in the top-down stress test was not reflected in the total own funds of banks.

[7] Report of the European Systemic Risk Board on vulnerabilities in the residential real estate sectors of the EEA countries of February 2022, available at https://www.esrb.europa.eu/pub/pdf/reports/esrb.report220211_vulnerabilities_eea_countries~27e571112b.en.pdf?421b2a7ec415416f4b9d6732d18af8d3

[8] Overall capital requirements and Pillar 2 guidance.

14. DNB considers that the proposed measure is necessary, suitable, effective, and proportionate. The measure targets exposures secured by residential real estate which according to DNB is one of the main domestic sources of systemic risk in the Netherlands. The main objective of the measure, which requires a sufficiently strong and stable amount of capital for residential real estate exposures, is to ensure that all banks which play an important role in mortgage lending are resilient against a potential severe downturn in the housing market. Dutch banks are highly exposed to the Dutch mortgage market as 21% of their assets, on average, are Dutch mortgage loans. The measure applies to banks which use the IRB approach for the calculation of capital requirements and that account for 92% of all mortgage lending by banks in the Netherlands. These banks report risk weights which the DNB deems low in light of growing vulnerabilities at the macro level. In contrast, the DNB does not target standardised risk weights as they are considered sufficiently high in relation to the systemic risk. As banks are systemically relevant, their resilience is especially important from a macroprudential perspective. By differentiating the average minimum risk weight based on the LTV of a mortgage, the measure is especially targeted at an important source of systemic risk in the Netherlands. High-LTV loans are more likely to have negative equity following a bust in the housing market. Negative equity has induced households in the past to reduce consumption and has prolonged the housing market bust. According to the DNB, the targeted nature and risk-sensitivity of the measure also contribute to its proportionality.

15. The DNB does not expect the measure to have a negative impact on the internal market that would outweigh the financial stability benefits of the measure. According to the DNB, the role of foreign lenders in the Dutch mortgage market is currently limited and domestic financial institutions are likely to remain dominant after this measure would be extended. Furthermore, the DNB argues that while the measure increases the risk weights for mortgage loans of Dutch IRB banks, risk weights resulting from its application would remain low compared to other Member States. Thus, the DNB expects limited cross-border spillovers. Finally, the DNB argues that by strengthening the resilience of the Dutch banking sector, the measure might reduce the potential contagion channels to other Member States.

Rationale for not using alternative measures

16. Regulation (EU) No 575/2013 and Directive 2013/36/EU offer various options for addressing macroprudential or systemic risks. Article 458(2)(c) and (e) of that Regulation requires the designated authority to demonstrate that the stricter national measure is suitable, effective, and proportionate, and why other possible measures (i.e., under Articles 124 and 164 of the Regulation (EU) No 575/2013 and Article 133 and 136 of Directive 2013/36/EU) would be less suitable and effective in dealing with the macroprudential or systemic risk identified than the said Article 458.

17. The current notification reiterates the previous justifications for deploying Article 458 of Regulation (EU) No 575/2013. The DNB considers the extension of the measure necessary and that alternative measures are still not adequate to address the identified risk.

- According to the DNB, a measure based on Article 124 of Regulation (EU) No 575/2013 would not adequately address the systemic risk, since banks that apply the standardised approach account for only a small fraction (around 5%) of all mortgage lending by banks. Therefore, a measure based on Article 124 of that Regulation would not have the desired impact on the resilience of the banking sector. Moreover, the risk weights of the standardised approach are substantially higher than the average risk weight for banks that use the IRB approach and are considered sufficiently high in relation to the systemic risk.

- The DNB considers a measure based on Article 164 of Regulation (EU) No 575/2013 as less efficient and effective than the currently active measure. Increasing the minimum exposure-weighted average loss given default (LGD) would predominantly affect loans with a low LGD which are generally the ones with lower LTV. By increasing the average LGD floor, banks with conservative lending standards (implying a lower LGD) would be penalised relatively more than banks with less prudent lending standards and could be incentivised to align their risk-taking with the higher (less conservative) LGD floor. Additionally, an increase of the LGD floor would interfere with the microprudential internal model of banks and could affect other areas, such as the calculation of expected loss amounts. Finally, the DNB stresses that using Article 164 of that Regulation would add complexity to the determination of capital requirements and reduce the transparency of IRB risk weights for market participants.

- The DNB sees using the systemic risk buffer (SyRB) in accordance with Article 133 of Directive 2013/36/EU, including its sectoral variant, as less efficient and effective than the currently active measure. The DNB argues that the risk weight floor is more risk-sensitive as it better prices the negative externality of high-LTV loans and thus, it better enhances the resilience of the banking sector. Moreover, the DNB notes that the measure results in a different risk weight for each loan depending on their LTV. This allows for a better targeting of risk than what can be achieved with a sectoral SyRB. In addition, the measure ensures that each bank maintains a minimum level of capital for their mortgage portfolio, regardless of the risk weights that the bank currently applies. Instead, a (sectoral) SyRB can only act as an add-on on the current risk weight and is thus less effective and efficient. To this regard, the DNB highlights that the risk weights on the relevant exposures have further decreased since the introduction of the measure. This, in the absence of the measure, would have resulted in a lower capital requirement for the affected IRB banks whereas the risks on a macro level have increased.

- DNB's current framework already aims at setting the countercyclical buffer rate, for determining the institution-specific countercyclical capital buffer (CCyB), in accordance with Article 136 of Directive 2013/36/EU, at 2% in a standard risk environment. The DNB announced on 25 May 2022 that it increased the countercyclical buffer rate from 0% to 1%.[9] However, the DNB notes that while the CCyB promotes resilience of the banking sector, it does not aim at specifically addressing the clearly elevated systemic risk levels present in

[9] https://www.dnb.nl/en/sector-news/2022/dnb-increases-countercyclical-capital-buffer-to-1-may-2022/

the housing market. Therefore, CCyB is also deemed as less efficient and effective than the current proposed measure. The CCyB is imposed on all credit exposures within the Netherlands and is thus not targeted towards the main source of the increase in systemic risk: the housing market. Further, the CCyB cannot be narrowed down to a subset of institutions. At last, DNB notes that the risk-sensitive approach of the current measure is not possible using the CCyB.

Assessment and conclusions

18. Based on the evidence provided by the DNB, the EBA acknowledges the concerns of the DNB regarding the increasing systemic risk stemming from the Dutch housing market over the past few years. The EBA further recognises the deterioration of risk indicators since the initial introduction of the measure. The EBA notes in particular the notable increase in house prices, the increase in LTVs and LTIs, an increasing share of interest-only mortgages as well as the declining share of mortgages with NHG coverage. Therefore, the EBA does not object to the 2-year extension of the current measure as long as the systemic risk stemming from the housing market persists.

19. The EBA notes that LTI ratios have increased, interest-only mortgages have regained popularity, the share of new mortgages with NHG coverage has decreased, and refinancing risks have increased due to rising mortgage interest rates. These developments occur in a time of increased financial pressures due to the current high inflation and higher energy costs for households. Taking note of this trend, the EBA encourages the DNB to monitor the effects of the measure on lending behaviour to ensure that the measure creates sufficient resilience and addresses the main drivers of the systemic risk identified in the Dutch housing market.

20. The EBA would like to comment on the suitability of the analysis for the calibration of the measure, considering the changing macro-financial risk environment since the introduction of the measure. The DNB based the initial calibration of the measure on a top-down stress test that relied on the adverse scenario of the 2018 EU-wide stress test exercise. Even though this scenario foresaw a severe decline in Dutch house prices, along with a moderate increase in interest rates and higher unemployment, it did not consider the potential impact of higher inflation. Therefore, the analysis only partially captures the impact of a sharp increase in interest rates while disregarding lower real income, which may both affect mortgage servicing capacity. An additional concern is the potential second round effects of declining real household consumption on the economy and the financial system. Thus, the EBA encourages the DNB to continue to monitor and to consider the appropriate calibration of the measure.

21. The EBA reiterates its concern on the use of stress testing for the calibration of the measure as it could lead, in certain situations, to a double counting of risks, which might not be intended by the relevant authority. The EBA would like to remind the DNB to continue monitoring the interaction with any Pillar 2 guidance already set following the finalisation of the 2021 EU-wide stress test and any Pillar 2 guidance that could be set following the finalisation of the 2023 EU-wide stress test.

22. The EBA would like to reiterate its reservations regarding the potentially pro-cyclical calibration of the measure. The measure calculates minimum risk weights using a constant component and a time varying component that is a function of an LTV metric based on current market prices.

    - The DNB expects based on 2021Q4 figures an increase of the total own funds for the targeted IRB banks at EUR 4.5 bn, up from the EUR 3 bn impact at the initial introduction. However, according to additional information provided, the increase in total own funds implied by the measure was mostly due to the decrease in the average IRB risk weights since the initial introduction of the measure and through the constant component of the floor calculation. On the other hand, the lower weighted average LTV of the IRB banks' relevant exposures had a downward effect on the impact of the measure, through its impact on the variable component of the floor calculation.

    - Thus, the EBA would encourage the DNB to monitor the possible pro-cyclical effect of the measure linked to the LTV metric and especially under the current strong increase in residential real estate prices.

    - Moreover, given the dominant role of the constant component of the measure in explaining the change of its impact since original introduction, the EBA would like to invite the DNB to monitor the risk sensitivity of the calibration.

23. The EBA shares the concerns of the DNB which deems the level of risk weights applied by IRB banks low, in light of growing vulnerabilities at the macro level. According to additional information provided by the DNB, the weighted average risk weight decreased from 11.1% to 8.3% between the assessment preceding the introduction of the measure and the assessment performed ahead of the notification for the extension of the measure. The EBA invites the competent authority to continue encouraging IRB banks established in the Netherlands to make appropriate efforts to continue developing their internal models and address any potential deficiencies, thus building appropriate capacity to withstand a severe economic downturn in the Dutch residential real estate market.

24. The EBA continues to see potential practical challenges in the reciprocation of the intended measures due to the use of a non-standardised LTV metric. The definition of the LTV metric may differ between the Netherlands and the other Member States. Therefore, some comparability issues may arise.

25. The EBA acknowledges that a sectoral SyRB would be less efficient than the current measure which ensures that the risk weight floor increases with the loan LTV on a loan-by-loan basis. While a sectoral SyRB could result in a similar overall outcome as the current measure, this would likely introduce undesirable additional complexity compared to the current measure.

This opinion will be published on the EBA's website.

Done at Paris, 6 September 2022

[signed]

José Manuel Campa
Chairperson
For the Board of Supervisors