EBA Op/2024/06

16 August 2024

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 22 July 2024, 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]

2. The notification concerns the two-year extension of a measure originally introduced by DNB on 1st January 2022 and already extended in December 2022 for two additional years up to 30th November 2024. The measure is 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 it is based on Article 458(2), point (d)(iv), of Regulation (EU) No 575/2013. The stricter requirement is applicable to credit institutions that use the Internal Ratings Based (IRB) approach for calculating regulatory capital requirements. The measure applies to exposures in scope which are not wholly or partly covered by the Dutch National Mortgage Guarantee scheme (NHG).[2]

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

4. In accordance with Article 458(4), second subparagraph, of Regulation (EU) No 575/2013, within one month of receiving the notification from the designated or competent authority entrusted

[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 amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1, ELI: http://data.europa.eu/eli/reg/2013/575/oj).

[2] The NHG scheme is a guarantee provided by a government-backed foundation, the Homeownership Guarantee Fund (Waarborgfonds Eigen Woningen, WEW), which covers 90% of the residual debt if a forced sale of the house is inevitable due to circumstances beyond the control of the borrower (job loss, becoming disabled, divorce).

with the national application of Article 458 of that Regulation, the EBA is required to provide its opinion on the points referred to in Article 458(2) of that Regulation to the Council, the European Commission and the Member State concerned.

5. In accordance with Article 14(2) of the Rules of Procedure of the EBA, the Board of Supervisors has adopted this Opinion.[3]

Background of the measure to be extended

6. The proposed measure under Article 458(2), point (d)(iv), of Regulation (EU) No 575/2013 is an extension of the current measure which is in place until 30th November 2024. The measure imposes a minimum average risk weight for institutions' 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 NHG. The mortgage loans guaranteed by the NHG account for 20%-25% of the institutions' mortgage portfolios. With the extension, the measure will be in force for two additional years, from 1st December 2024 until 30th November 2026.

7. The exposure-weighted average of risk weights, as calculated by the measure, acts as a minimum average risk weight at the portfolio level. At the first stage, 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 to secure the loan, and a 45% risk weight is assigned to the remaining portion of the loan. At the second stage, the binding exposure-weighted floor is calculated by weighting the individual loan risk weights by their exposure values. Thus, the risk weights of individual loans in scope and for the purpose of the risk weights floor increase with the Loan-To-Value (LTV) ratio of the loans: from 12% for loans with an LTV ratio up to 55% to, for example, 26.85% for loans with an LTV ratio of 100%. The continuous approach helps to avoid any distortions due to cliff effects. The LTV continues to be calculated using the market value of collateral.

8. The design and the calibration of the measure remain unchanged compared to the activation and first extension of the measure. DNB assesses that the intensity of the systemic risk in the residential real estate market in the Netherlands has increased since the time of activation and it has stabilised at elevated levels with upward pressure, since the first extension of the measure. Based on 2023Q4 data, DNB expects the additional amount of CET1 capital due to the extension of the measure at EUR 2.4 bn for the institutions in scope, slightly lower than in 2022. The impact is due to the resulting increase of the average risk weight by about 4 percentage points from a pre-floor level of around 12% for exposures covered by the measure to be extended to 16% after applying the floor to the same exposures.

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

9. In its Opinions dated 6 February 2020[4] and 6 September 2022,[5] the EBA did not object to the activation and subsequently the first extension of the measure. In its Opinions, 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 of IRB institutions.

10. In its Opinion dated 6 September 2022, the EBA had some comments regarding the calibration of the measure, its design, and its impact including the following observations:

- The calibration of the measure continued to rely on a top-down stress test that used the adverse scenario of the 2018 EU-wide stress test exercise and therefore, it only partially captured the impact of sharp increases in interest rates and lower real incomes emerging at the time of the first extension. Both factors can affect mortgage servicing capacity. For the notified extension of the measure, the DNB has updated the stress test scenario used.

- Further, the EBA reiterated its concerns on the use of stress tests to adjust risk weights which can, in certain situations, lead to a double counting of risks, which might or might not be intended by the relevant authority.

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

- The EBA continued to remind the competent authority to continue encouraging IRB institutions established in the Netherlands to make the appropriate efforts to develop 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.

Opinion on the extension

Economic rationale for the measure

11. The DNB has notified an extension of the period of application of the currently applicable measure by two years, starting on 1st December 2024. This extension aims to maintain the resilience of institutions against a potential severe downturn in the residential real estate market in the backdrop of sustained real estate price increases over the past years. DNB assesses that, from a macroprudential perspective, the current level of IRB risk weights does not

[4] Opinion of the European Banking Authority on measures in accordance with Article 458 Regulation (EU) No 575/2013 of 6 February 2020 (EBA/Op/2020/03) available at [EBA-Op-2022-09 Opinion of the EBA on measures in accordance with Article 458 of Regulation (EU) No 5752013.pdf (europa.eu)]

[5] Opinion of the European Banking Authority on measures in accordance with Article 458 Regulation (EU) No 575/2013 of 6 September 2022 (EBA/Op/2022/09) available at [EBA-Op-2022-09 Opinion of the EBA on measures in accordance with Article 458 of Regulation (EU) No 5752013.pdf (europa.eu)]

appropriately reflect the high and persistently elevated systemic risk in the housing market in the Netherlands.

12. DNB, in its notification, argues that the level of systemic risk in the housing market has increased over the past few years. Sharp house price increases are observed over several years with a peak in the year-on-year growth rate recorded in January 2022 at 21.1%. After a short-lived and modest decline of house prices during 2022 and 2023, the house price index grew again in December 2023. According to the notification, the yearly growth rates of house prices stood at +7.5% in April 2024 and +8.6% in May 2024 resulting in the level of the house price index exceeding its previous peak recorded in July 2022. Signs of overvaluation remain present as the price-to-income ratio remains considerably higher than the euro area, while evidence from the ESRB also points to overvaluation of approximately 20%.[6] In the first quarter of 2024, more than half of houses in the market were sold above the asking price and the average transaction period is 34 days. Moreover, a scarcity indicator (houses sold divided by houses for sale) is rising above levels observed during the time of first notification (begin 2020).

13. According to DNB, institutions in the Netherlands continue to be especially vulnerable to a correction in the housing market. Their exposures towards residential real estate mortgages remain high and are currently at one of their highest levels, slightly above 21% of banks' total assets. At the same time, banks are responsible for around 70% of all mortgage lending in the Netherlands. DNB, using an update of an internal top-down stress test with the 2023 EU-wide stress test scenario finds that the additional capital to account for unexpected losses on banks' residential real estate portfolios is similar to that calculated for the initial calibration of the measure. Additionally, DNB tested banks' resilience against a historical scenario featuring the most severe cumulative increase in the loss rate of the mortgage portfolios observed over a three-years horizon in the historical data. The results suggest, according to the notification, that the overall systemic risk is at an elevated level, as total credit losses are in line with those estimated ahead of the initial activation of the measure.

14. At the same time, Dutch households continue to have high debt levels at around 94% of GDP as of end 2023, considerably higher than the euro area average of 54%[7] of GDP over the same time. High indebtedness makes Dutch households vulnerable to a downward correction in the housing market. As prices drop, high-LTV mortgage holders could end up with negative equity (LTV ratio above 100%). Furthermore, these. homeowners are expected by DNB, based on experience from the housing crisis that occurred during 2008-2013, to consume less as they prioritise servicing their debts. Thus, institutions could also suffer from a housing market correction through indirect effects, as the negative economic impact will reduce their profitability and increase their risk weighted assets (RWA).

[6] ESRB Risk Dashboard, Production date: 7 March 2024 available at [ESRB risk dashboard, March 2024 (Issue 47) (europa.eu)]

[7] Source: ECB Quarterly Sector Accounts, Loans granted to households as a ratio of GDP, Euro area 20 (fixed composition) as of 1 January 2023, Quarterly.

15. DNB considers that the proposed extension of the measure is suitable, effective, and proportionate. The main objective of the measure is to ensure that institutions are resilient against a potential severe downturn in the housing market. Imposing a minimum risk weight for IRB institutions creates a sufficiently strong and stable amount of capital for residential real estate exposures. With its calibration, the measure helps to secure the resilience of the banking sector in a severe downturn scenario, and it is thus, suitable and effective. The stress test conducted by DNB shows that the credit losses are in line with those estimated ahead of the initial activation of the measure. Moreover, DNB considers the measure proportionate. The measure differentiates the minimum risk weight based on the LTV of a loan and therefore, it targets an important source of systemic risk in the Netherlands. High LTV loans are expected to prolong a housing market correction via lower consumption. By linking the minimum risk weight floor to the LTV of a loan, the measure avoids making risky mortgages with higher LTV more attractive to institutions than safer mortgages with lower LTV. In this way, the measure can also disincentivise institutions to grant new high-LTV loans. According to DNB there is no evidence that the measure has led to more risky mortgage lending over years 2022 and 2023. Moreover, the measure increases the resilience of institutions which are systemically relevant and which play an important role in mortgage lending and are therefore important from a macroprudential and financial stability perspective. At the same time, the measure only targets residential real estate exposures which are one of the main sources of systemic risk in the Netherlands. At last, the measure only affects institutions that use the IRB approach which account for 96% of all mortgage lending by banks in the Netherlands.

16. DNB does not expect the extension of 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 continues to be small and domestic financial institutions are likely to remain the main players in the residential mortgage loan market after this measure is extended. Furthermore, the DNB argues that while the measure increases the risk weights for mortgage loans of Dutch IRB institutions, risk weights resulting from its application would continue to remain low compared to other Member States. Thus, the DNB expects limited cross-border spillovers as the measure would not provide a substantial incentive to shift exposures. Finally, the DNB argues that by strengthening the resilience of the Dutch banking sector, which is interconnected with the European and global financial system, the measure might reduce the potential contagion channels to other Member States.

Rationale for not using alternative measures

17. Regulation (EU) No 575/2013 and Directive 2013/36/EU[8] offer various options for addressing macroprudential or systemic risks. Article 458(2), letters (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 that

[8] 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, ELI: http://data.europa.eu/eli/dir/2013/36/oj).

Regulation and under Articles 133 and 136 of Directive 2013/36/EU) would be less suitable and effective in dealing with the macroprudential or systemic risk identified than measures in accordance with Article 458(2)(d) of that Regulation.

18. The current notification reiterates the previous justifications for deploying the measure under Article 458(2), point (d)(iv), of Regulation (EU) No 575/2013. The DNB considers the extension of the measure necessary and assesses that the 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 and would not have the desired impact on the resilience of the banking sector, since institutions that apply the standardised approach account for only a small fraction (around 5%) of mortgage lending by institutions. Moreover, the average risk weights of the standardised approach are substantially higher than the average risk weight for institutions that use the IRB approach and are considered sufficiently high in relation to the systemic risk.

- The DNB continues to consider 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, institutions with conservative lending standards (implying a lower LGD) would be penalised relatively more than institutions 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 institutions and could affect other areas, such as the calculation of expected loss amounts. Finally, the DNB stresses that using Article 164 of Regulation (EU) No 575/2013 would add complexity to the determination of capital requirements and reduce the transparency of IRB risk weights for market participants.

- The DNB assesses the use of 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 extension of the currently active measure. The DNB argues that the risk weight floor is more risk-sensitive as it prices better the negative externality of high-LTV loans and thus, it safeguards 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 can address heterogeneity in risk weights by ensuring that each institution maintains a minimum level of capital for their mortgage portfolio, regardless of the risk weights that the institution currently applies. According to the notification, a (sectoral) SyRB can only act as an add-on on the current risk weight as it cannot address the dispersion of IRB risk weights across institutions and thus, it is less effective and efficient. According to DNB, the risk weights floor is associated with less pro-cyclical effects than the sectoral SyRB as the impact of a sectoral SRB would decrease in case of a period with increasing systemic risk and decreasing IRB risk weights. Nevertheless, DNB emphasised that they will continue to monitor unintended procyclical effects.

- DNB notes that while the countercyclical capital buffer (CCyB) under Article 136 of Directive (EU) 36/2013 supports the resilience of the banking sector, it does not aim to specifically address the elevated systemic risk levels present in the housing market and therefore, the CCyB is deemed as less efficient and effective than the minimum average risk weight measure. The CCyB is imposed on all credit exposures within the Netherlands and it is not targeted towards the housing market exposures. Further, the CCyB cannot be narrowed down to a subset of institutions such as these using the IRB approach. At last, DNB notes that the risk-sensitive approach of the minimum average risk weight measure, which prices-in the negative externality of high-LTV loans, is not possible using the CCyB.

Assessment and conclusions

19. Based on the updated evidence provided, 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 in the Netherlands persists. In its assessment, the EBA takes note of the continued elevated level of systemic risk related to the housing market in the Netherlands. The EBA further recognises the cumulative increase of house prices over the past few years and the persistent signs of overvaluation, despite the contraction of the house price index following the recent tightening in monetary policy. The EBA continues to acknowledge the risks from the high household indebtedness in the Netherlands and the large share of institutions' exposures to the residential real estate mortgage market, including high-LTV loans. The EBA assessment is also based on recent evidence by the ESRB on the continued elevated risks related to the residential real estate market in the Netherlands.[9]

20. Compared to its Opinion dated 6 September 2022, the EBA reiterates its concerns about the use of stress testing and similar scenario analysis for the calibration of the measure. The use of stress testing could lead, in certain situations, to a double counting of risks, which might not be intended by the relevant authority. The EBA invites the DNB to continue monitoring any possible interaction with Pillar 2 guidance already set following the finalisation of the 2023 EU-wide stress test and Pillar 2 guidance that could be set following the finalisation of the 2025 EU-wide stress test.

21. In addition, the EBA draws attention to the requirements for the calculation of the LTV metric which determines the minimum average risk weight. This metric is based on the market value of collateral. This definition differs from the requirements laid down in Article 229 of the

[9] ESRB Follow-up report on vulnerabilities in the residential real estate sectors of the EEA countries, February 2024, available at https://www.esrb.europa.eu/pub/pdf/reports/esrb.report.vulnerabilitiesresidentialrealestatesectors202402~df77b00f9a.en.pdf?d862a6be57d42a021d79e3e16cfd305b

Regulation (EU) 575/2013, as amended by Regulation (EU) 2024/1623[10] that will be applicable during the extension of the measure. This could lead to potential divergence with other regulatory requirements and potentially divergent practices across institutions if different approaches are used to update the market value of collateral. The EBA invites the DNB to continue monitoring any discrepancies in the determination of the market value of the collateral that may arise following the application of Regulation (EU) 2024/1623 vis-à-vis the definitions applying to the LTV for the purpose of the current measure.

22. At last, the EBA points to the potential for unintended overlaps of the extended measure with the output floor introduced via Regulation (EU) 2024/1623 amending Regulation (EU) No 575/2013 in the case one or more institutions become bound by the output floor. On this note, the EBA invites the DNB to monitor any overlaps between the minimum average risk weights measure with the output floor and to stand ready to review the calibration of the minimum average risk weight measure to ensure that the calibration of the latter remains appropriate.

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

Done at Paris, 16 August 2024

[signed]

Jose Manuel Campa

Chairperson
For the Board of Supervisors

[10] Regulation (EU) 2024/1623 of the European Parliament and of the Council of 31 May 2024 amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor (OJ L, 2024/1623, 19.6.2024, ELI: http://data.europa.eu/eli/reg/2024/1623/oj).