

ASSESSMENT OF THE NEED TO MAINTAIN THE RISK WEIGHT FLOOR OF 15% FOR MORTGAGE LOANS (JULY 2023)

SUMMARY

A requirement has been in force in Estonia since 30 September 2019 for the IRB banks, which are banks that use the internal ratings based (IRB) approach, to apply a risk weight of at least 15% to the portfolio of mortgage loans issued to residents of Estonia when risk-weighted assets are calculated for assessing capital requirements. In the spring 2023 assessment, Eesti Pank decided to extend the requirement by two years from 30 September 2023.

Justification for extending the requirement. The systemic risks that caused the measure to be introduced have not diminished over recent years. Rapid credit growth means that households are more vulnerable, and rising housing prices have caused overvaluation to increase. There remains the danger of the risk weights used in the internal models of the IRB banks insufficiently reflecting a possible increase in systemic risk. The floor that has been set helps to prevent the risk weighting applied in the calculation of the capital requirements from falling too low.

The risk weight floor rate	15%
Risk position	Retail exposures secured by real estate to residents of Estonia
Scope	Banks using the Internal Ratings Based approach at an individual and consolidated level
Entry into force	30.09.2019
Legal basis	Regulation (EU) no 575/2013 article 458
Decree	Decree No 6 of the Governor of Eesti Pank of 27 August 2019, " Setting a minimum level of risk weight for retail exposures secured by real estate property ".

1. DESCRIPTION, AIM AND REASONING OF THE CURRENT MEASURE

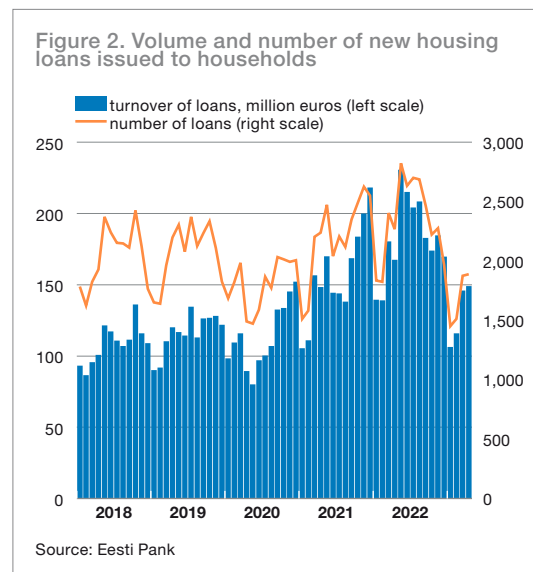
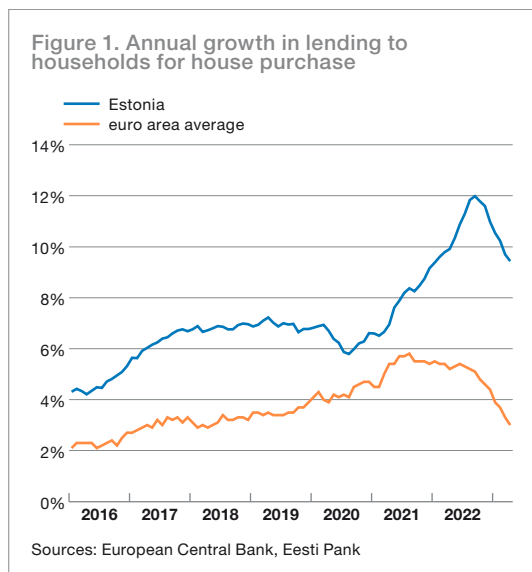
Description of the measure. The IRB banks operating in Estonia have since 30 September 2019 had to use an average risk weight of at least 15% for retail exposures secured by real estate, or mortgage loans, when calculating risk-weighted assets. The floor has been set for the average of the portfolio, which means that the risk weights of individual loans may be below that floor rate. The IRB banks must meet the average risk weight floor requirement on an individual and a consolidated basis.

Aim and reasoning. The aim of the measure is to ensure the resilience of the banks to the risks associated with housing loans. The requirement was introduced in 2019 because at a time when the risks from consistently rapid growth in housing loans were above the medium level, the weighted average risk weight for mortgage loans of the IRB banks had come down quite substantially. It was decided to respond to this with a minimum requirement for the average risk weight to prevent it from falling further. If the risks weights underestimate the risk level, the danger could arise of banks being insufficiently conservative in their calculations for risk-weighted assets, and so not being sufficiently capitalised against possible risks from housing loans. As housing loans are an important part of the assets of the banks and the IRB banks account for a substantial part of the housing loan market in Estonia, an excessive fall in the risk weights could increase the risks to financial stability in Estonia.

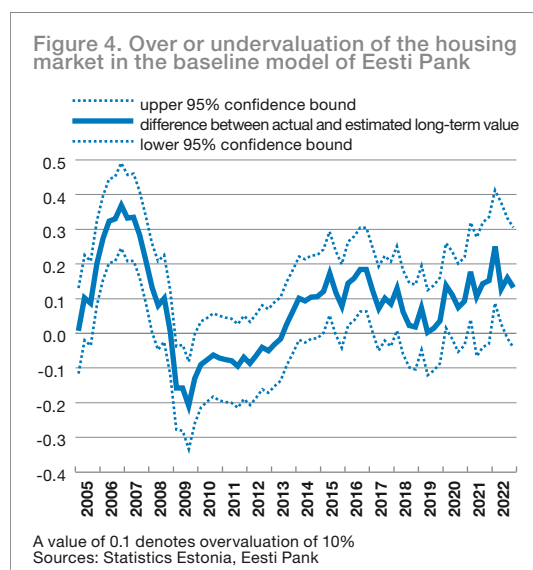
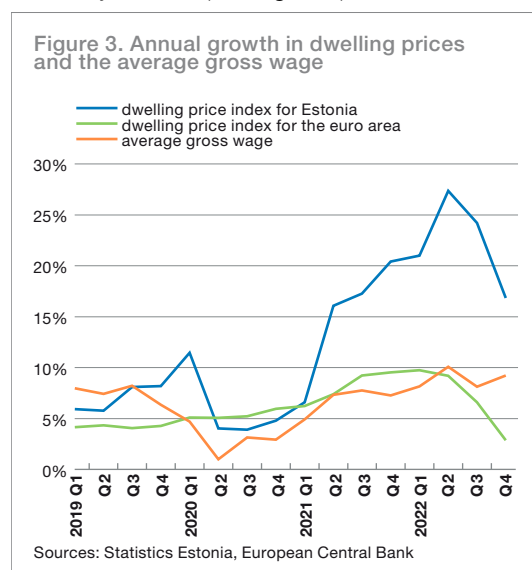
2. DEVELOPMENT OF SYSTEMIC RISKS

HOUSING LOANS AND HOUSEHOLD INDEBTEDNESS

One of the more serious vulnerabilities for financial stability in Estonia comes from the rapid growth in housing loans. The yearly growth in the stock of housing loans issued by Estonian banks was around 7% in 2017–2019. The real estate market recovered quickly from the impact of the outbreak of the Covid-19 pandemic in spring 2020 and was extraordinarily active in the next two years, with yearly growth in housing loans reaching 12% in autumn 2022 (see Figure 1). Demand for housing loans was boosted by the rapid growth in the incomes of households, the savings they had accumulated, and the option of withdrawing savings from the second pension pillar for those who wanted to. Demand for loans was encouraged by interest rates being at record low levels¹. The number of loans issued was around 15% higher in both 2021 and 2022 than in previous years (see Figure 2).



As demand increased, so did real estate prices. Housing prices rose notably faster than household incomes in 2021 and 2022 (see Figure 3). Real estate prices were almost a quarter higher in the third quarter of 2022 than in the same quarter of the previous year. The rise in the price of housing in Estonia was clearly above the average rise in price in the euro area. The Eesti Pank models used to estimate over or undervaluation in the real estate market show that housing prices might be on average overvalued by 10-15% (see Figure 4).

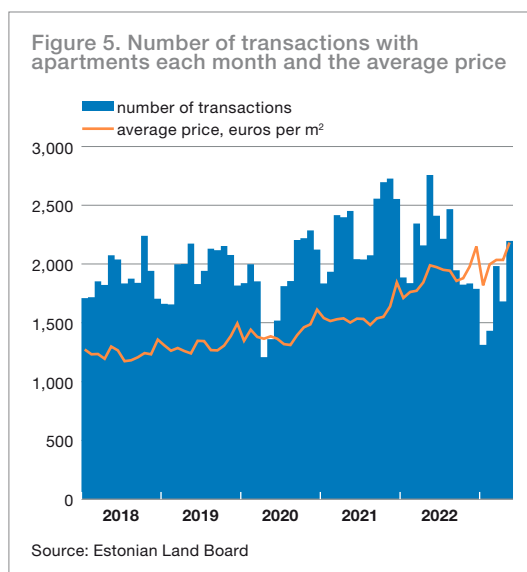


1 For more see the [Financial Stability Review No 1/2023](#).

The rapid rise in housing prices also increased the average amount borrowed and the loan burden. There was a notable increase in 2022 in the share of new housing loans where the loan repayments remained just below the limit set by Eesti Pank², given the possible rise in interest rates. This requirement is that the monthly costs of servicing the loan may not exceed 50% of the income of the borrower. The share of loans with the maximum permitted maturity of 30 years also increased, which further indicates that new loans have been issued with a higher risk profile.

General inflation, reduced confidence and a sharp rise in Euribor in the second half of the year combined to cool demand, but data for spring 2023 show it recovering gradually. The

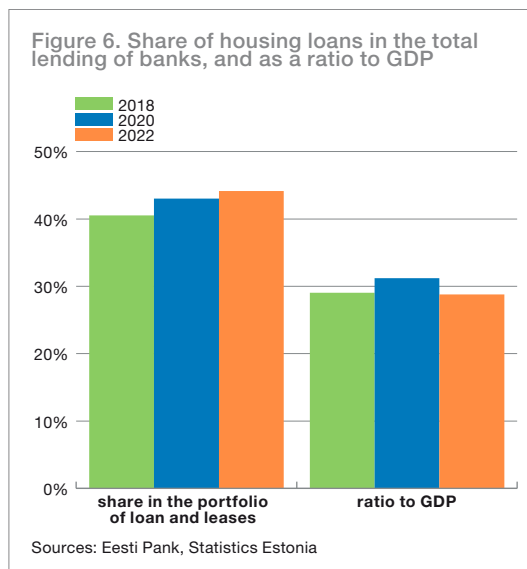
number of transactions in May 2023 was a little lower than it was a year earlier, but the average price of transactions was almost a tenth higher (see Figure 5).



THE SHARE OF HOUSING LOANS AND MARKET CONCENTRATION

Housing loans make up a large part of the loan portfolio of the banks. This exposes the banks to disadvantageous impacts on the ability of households to pay or on the real estate market. The share of housing loans in total loans to the non-financial sector is one percentage point higher than in 2020 at 44%. Housing loans as a ratio to GDP were 29% at the end of the third quarter of 2022 (see Figure 6).

The level of concentration is high for housing loans, and the two IRB banks have issued about three quarters of the total value of housing loans. The market share for housing loans of the larger banks has receded a little in recent years, but those two banks still issue around two thirds of all new loans. This means that if the IRB banks with large market share underestimate the risks, their capital buffers may be insufficient, and that could affect the financing of the whole economy.



THE EESTI PANK RISK ASSESSMENT

Continued rapid growth in loans would increase the risks to the banking sector. The Eesti Pank spring forecast 2023 expects that developments in the economy will not deal a major blow to the ability of households to cover their loans, and the growth in housing loans will remain quite strong in the coming years. Growth recovering depends on the confidence of households and their financial position. Euribor rising by more than expected could cool demand, though the strong labour market and continuing growth in wages will help make housing more affordable again.

The recent strong growth in borrowing as the growth in the economy slows points to an increase in risks. The Eesti Pank forecast expects inflation to fall this year. The indebtedness of households may

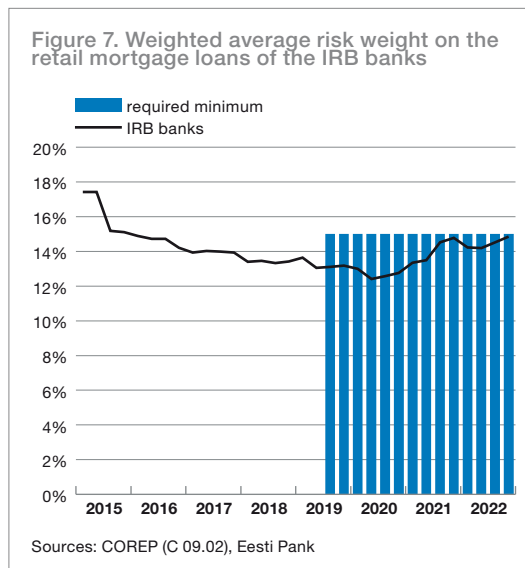
² The requirements set by Eesti Pank find the debt service-to-income (DSTI) by calculating from loan payments using an interest rate of 6% or the actual interest rate plus two percentage points, whichever is higher.

start to increase again if growth in the economy is only moderate, meaning households will have to cope with larger loan repayment burdens. General inflation and rising interest rates have at the same time reduced the savings of households. If the economic climate were to deteriorate unexpectedly, the impact on the banks could consequently be greater.

3. DYNAMICS OF RISK WEIGHTS AND THE NEED FOR THE MEASURE

The model-implied **weighted average** risk weight on mortgage loans of the IRB banks operating in Estonia was 14.9% at the end of 2022. The average risk weight stabilised at below 13% in 2020 after falling for several years. Risk weights then rose, and since the second half of 2021 the average figure for the IRB banks has been above 14% (see Figure 7).

The risk weights found using the internal models of the banks take account of the size of losses on housing loans in previous years. The average risk weights have fallen mainly because the economic climate in Estonia has generally been favourable for the past decade and more. The share of loans overdue or **non-performing loans** has fallen further in recent years, and it was 0.3% of the total volume of mortgages issued by the IRB banks at the end of 2022. The average share of problem loans in the banking sector has fallen from 1.5% two years ago to 0.4%.



The floor set by Eesti Pank has helped limit the fall in the risk weight on mortgage loans. Eesti Pank introduced a 15% floor on 30 September 2019 on the average risk weights on mortgage loans of the IRB banks because the downward trend in risk weights did not necessarily reflect accurately the risks from housing loans. The ability of households to meet their loan obligations could be severely reduced in a harsher economic climate than that of today, and that needs to be considered when calculating the risk level of assets. For this reason, the Eesti Pank rule requiring IRB banks to apply an average risk weight of at least 15% to retail loans backed by real estate is still applicable.

4. THE IMPACT OF THE RISK WEIGHT FLOOR

IMPACT ON CAPITALISATION

The floor of 15% for the weighted average risk weights of mortgage loans increased the risk assets used as a basis for the capital requirements of the IRB banks by 196 million euros as at 31 December 2022. The aggregate impact on the capital adequacy ratio was estimated at 0.6 percentage point. Both of the IRB banks held substantial capital buffers in Estonia at the end of 2022 that were more than sufficient to meet the requirement, as the weighted average ratio of total own funds of the IRB banks was 26.5%.

IMPACT ON HOUSEHOLDS AND LENDING ACTIVITY

The direct negative side-effects of the measure on the Estonian economy have been limited, as it applies only to loans secured by real estate that are issued to retail clients in Estonia. This means that the measure has not had a significant impact on the other activities of the banks, such as corporate funding. Neither has the restriction limited the issue of housing loans, as the own funds of the banks have exceeded the capital requirements with sufficient margin.

CROSS-BORDER IMPACT

The cross-border impacts of the measure are very small. The requirement does not apply to branches operating in Estonia, or to the cross-border services provided by banks from other countries. At the end of 2022 there were five branches of foreign banks operating in the Estonian market, and they had issued around 1% of all the housing loans between them. As the activity of branches in the Estonian housing market has been relatively modest, Eesti Pank has not considered reciprocity of the requirement in the home countries of the branches to be necessary. Banks from other European Union member states have issued very little in housing loans, and so that lending does not have any particular impact in the local lending market.