ASSESSMENT OF THE NEED TO MAINTAIN THE RISK WEIGHT FLOOR OF 15% FOR MORTGAGE LOANS (JULY 2021)

SUMMARY

A requirement has been in force in Estonia since 30 September 2019 for the IRB banks, which are credit institutions 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 2021 assessment, Eesti Pank decided to extend the requirement by two years from 30 September 2021.

Justification for maintaining the requirement. The systemic risks that caused the measure to be introduced have not diminished over the past two years. After the shock in spring 2020 caused by the uncertainty surrounding the pandemic, the real estate and housing loan markets recovered strongly in the second half of the year. The risk assessment in spring 2021 indicated an increased risk of rapid growth in mortgage loans. The risk of house prices being overvalued has increased somewhat as well. The model-implied average risk weight of mortgage loans issued by the IRB banks has however continued to fall, reaching 12.8% by the end of 2020. The floor of 15% helps to prevent the risk weights applied in calculation of the capital requirements from falling further.

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 at an individual and a consolidated level.

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 risks weights were to fall too low, 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, a further 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 growth in housing loans. Excluding spring 2020, when the housing market was temporarily hampered by the outbreak of the Covid-19 pandemic, the **rate of growth in housing loans** has remained at around 7% for the past four years (see Figure 1). The real estate market recovered rapidly from the shock caused by the uncertainty surrounding the pandemic, and in spring 2021 demand for residential property and for loans to purchase it was greater than before the crisis. The growth in housing loans was also fast in several other European Union countries, but the rate of growth in housing loans in Estonia has remained relatively high for several years now. The rate of growth in housing loans in Estonia last year was around one and a half times as fast as the average in the euro area.

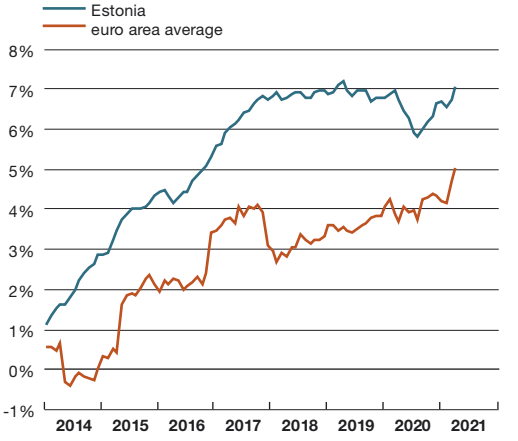
The housing loan portfolio grew at a faster rate in 2020 than GDP and household incomes did, meaning that the **indebtedness of households** started to rise, having remained stable for several years (see Figure 2). The rise was driven by housing loans, while the other loans of households declined last year.

ACTIVITY AND PRICE RISES IN THE HOUSING MARKET

Activity started to increase in the real estate market in the second half of 2020, and picked up further in the final months of the year. **The number of transactions** was boosted partly in spring by transactions that had been postponed. The number of transactions was a little lower in the first quarter of 2021 than in the fourth quarter of 2020, as is typical of the first quarter of the year, but prices continued to rise and demand in the housing market remained strong, particularly demand for new apartments (see Figure 3).

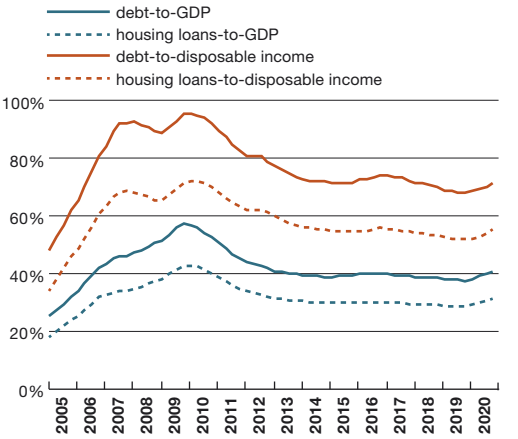
Housing prices recovered rapidly after their temporary fall in spring 2020. The average price is affected to some extent by the structure of transactions, where a larger share of new properties generally raises the figure for the average price. Data from Statistics Estonia show that the average square metre price of housing was 4.8% higher by the end of the year than it was a year earlier, and this increased in the first quarter of 2021 to 6.6%.

Figure 1. Annual growth in the portfolio of housing loans



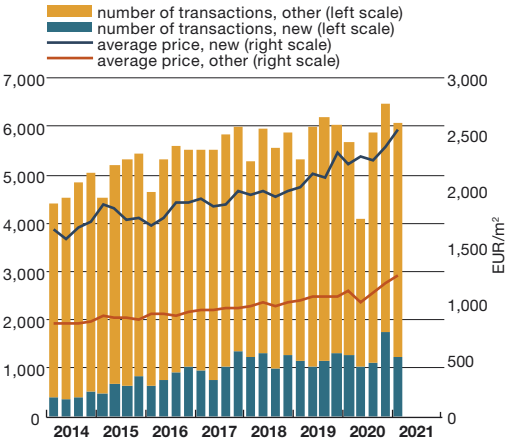
Sources: European Central Bank, Eesti Pank

Figure 2. Household indebtedness



Sources: Statistics Estonia, Eesti Pank

Figure 3. Number of transactions with apartments and the average price



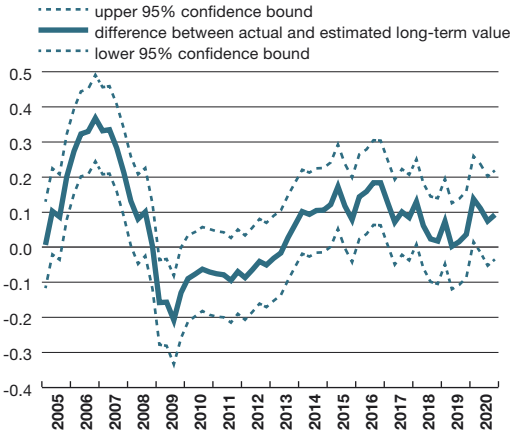
Source: Estonian Land Board

Several factors have driven the increased demand for housing, primarily the continued relatively strong growth in incomes in several sectors, increased saving as a consequence of changes in consumption patterns, lower interest rates, and more[1]. Demand for housing may be increased even further this year and price rises given an extra boost by the savings withdrawn from second pillar pension funds being put into real estate. Given the relatively high price levels of housing, it may be assumed that the savings built up in the second pillar will be used alongside funds saved in bank deposits primarily as down payments alongside borrowed money.

Prices of residential real estate are also affected by supply, including the **amount of new residential space.** The number of apartments for sale fell in the first months of 2021, which occurred because the uncertainty in spring 2020 led developers to postpone the start of construction work. Demand reacted strongly to the recovery though and supply is expected to increase in future. Although the pressure put on prices by the supply shortages will decline over time, the rise in construction costs will affect the price level of new residential space in the future.

The risk of **prices in the housing market becoming overvalued** has increased. Eesti Pank's model shows the probability of overvaluation in the real estate market has increased slightly from what it was in 2018 and 2019 (see Figure 4). Given the continuing rise in real estate prices and the more restrained outlook for growth in the average wage, it may be assumed that the housing market in Estonia will become more overvalued in the quarters ahead.

Figure 4. Over or undervaluation of the housing market in the baseline model of Eesti Pank



* A value of 0.1 denotes overvaluation of 10%.
Sources: Statistics Estonia, Eesti Pank

THE SHARE OF HOUSING LOANS AND MARKET CONCENTRATION

The **share of housing loans** remains large in the assets of the banks, which makes the banks sensitive to any negative change affecting loan servicing by households or the real estate market. Growth recovered in the housing loan portfolio in the second half of 2020 to close to where it was before the crisis, while corporate loans and private consumption loans did not grow as fast at the same time, and so the share of housing loans in loans to the non-financial sector increased over two years from 41% to 43%.

Although it has declined, the level of **concentration in the Estonian housing loan market** remains high. Housing loans are mainly provided by banks in Estonia, and lending has become concentrated at individual large market participants. Swedbank and SEB, the two IRB banks, had 75% market share for the housing loan portfolio by volume at the end of 2020, which was the same as it was two years earlier. Although both the IRB banks lost a little market share for issuing new loans during 2020, they still held 70% of the market. If the IRB banks with the large market share were to underestimate the systemic risks associated with lending to households or with the real estate market, their capital buffers could prove insufficient in the event of a negative shock. This could then threaten the functioning of the entire banking system.

THE EESTI PANK RISK ASSESSMENT

Continued rapid growth in loans would increase the risks to the banking sector. The Eesti Pank June forecast 2021 expects the housing loan portfolio to grow in the years ahead at an annual rate of around 8%. If loans were to grow on average faster than the economy as a whole and than incomes, the household debt burden would continue to increase. A high level of indebtedness makes

1 For more see the Financial Stability Review No 1/2021.

households more vulnerable to any possible fall in incomes or rise in interest rates. As housing loans are a large and growing part of the loan and lease portfolio of the banks, the current rapid growth in loans could cause significant loan losses for the banks in the future should there be a serious blow to the ability of households to pay or to the real estate market.

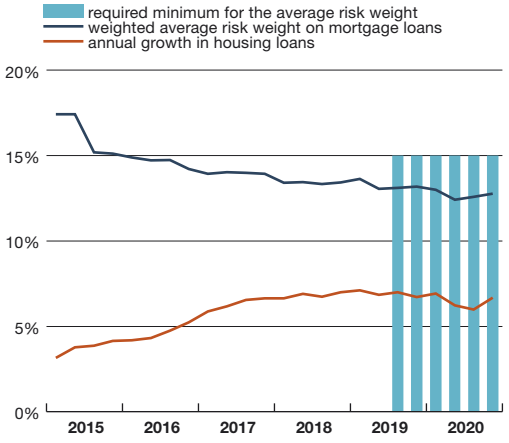
3. DYNAMICS OF RISK WEIGHTS AND THE NEED FOR THE MEASURE

There are two IRB banks in Estonia, Swedbank and SEB. The model-implied **weighted average risk weight** on mortgage loans of those banks has fallen over the past five years, and it was 12.8% by the end of 2020 (see Figure 5)[2].

The risk weights found using the internal models of the banks take account of the size of losses on housing loans in previous years. Risk weights have fallen because the good state of the economy in Estonia in recent years and low interest rates have meant that the quality of housing loans has been good and the models assess that the probability of repayment problems arising has fallen steadily year by year.

The **share of loans overdue** has fallen sharply and reached its lowest level of the past couple of decades. In the previous economic crisis, over 4% of housing loans were overdue by more than 60 days, but at the end of 2020 only 0.2% were. The estimates of the internal models of the IRB banks may also start to be affected by the emergence of loan losses following the pandemic, but the impact of this on the risk weights is likely to be minor.

Figure 5. Growth in housing loans and the average risk weight on mortgage loans of the IRB banks



Sources: Finantsinspektsioon, Eesti Pank

The floor set by Eesti Pank has helped limit the fall in the risk weight on mortgage loans. Because the downward trend in risk weights did not necessarily reflect accurately the risks from housing loans, Eesti Pank introduced a 15% floor on 30 September 2019 on the average risk weights on mortgage loans of the IRB banks. Rapid growth in loans could make households more vulnerable to potential risks 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 secured by real estate is still applicable.

4. THE IMPACT OF THE RISK WEIGHT FLOOR

IMPACT ON CAPITALISATION

Setting 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 2.2% as at 31 December 2020. The impact on the capital adequacy ratio was estimated at 0.8 percentage point. Both of the IRB banks held substantial capital buffers in Estonia at the end of 2020, with a weighted average CET1 ratio of 35.7%, and this has helped them to comply with the capital requirements.

Eesti Pank carried out a stress test in 2019 to calibrate the risk weight floor requirement, with a negative scenario that assumed a repeat of the shock delivered by the economic crisis in 2009-2010[3]. The analysis found that the loan losses on housing loans in this scenario could reach around 1.4% of the housing loan portfolio. The assessment in spring 2021 was similar to that two years ago, finding that

2 The risk weights of the other banks that use the standard method are fixed at 35%.

3 See the analysis of the introduction of a risk weight floor for mortgage loans (September 2019)

the growth in household incomes and savings and the support measures introduced because of the pandemic had probably supported the capacity of households to pay. Loan losses in the stress scenario could reach 0.7% of total risk exposures, which could be covered from existing buffers because the banks are well capitalised.

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 banks are well capitalised.

The impact on the loan margins of the banks and on loan growth is estimated to have been small. The average interest margins of the IRB banks have come down a little since the first half of 2019 because of the increase in competition between the banks. The measure applied to the IRB banks in Estonia does not impact the activities of other lenders. Banks dominate lending for housing loans in Estonia, and the role of non-bank creditors in issuing such loans is very small.

CROSS-BORDER IMPACT

The cross-border impacts of the measure are very small. More than 99% of the mortgage loans issued to the retail clients of the Estonian IRB banks have been issued in Estonia. 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 2020 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. There has been very little issuance of cross-border housing loans from other European Union member states, and so it does not have any particular impact in the local lending market.