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From:	European Commission
date of receipt:	25 August 2017
To:	Mr Toomas TONISTE, President of the Ecofin Council
No. Cion doc.:	C(2017) 5734 final
Subject:	COMMISSION DECISION of 21.8.2017 not to propose an implementing act to reject the proposed national measure notified on 27 June 2017 by Finland under Article 458(4) of Regulation (EU) No 575/2013 of the European Parliament and of the Council

Delegations will find attached document C(2017) 5734 final and the accompanying letter from Mr Olivier GUERSENT, Director General to Mr Toomas TONISTE, Minister of Finance of Estonia.

Encl.: C(2017) 5734 final

EUROPEAN COMMISSION
Directorate-General for Financial Stability, Financial Services and Capital Markets Union

Director General

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Mr Toomas Tõniste
Minister of Finance of Estonia
Presidency of the Ecofin Council
Rue de la Loi 175
B – 1048 Brussels

Subject: **Commission Decision on not to propose an implementing act to reject the proposed national measure notified on 27 June 2017 by Finland under Article 458(4) of Regulation (EU) No 575/2013 (CRR)**

Dear Mr Tõniste,

I would like to inform you of the Decision taken by the European Commission in respect of the notification received from the Finnish Financial Supervisory Authority ("FIN-FSA") on 27 June 2017 regarding the proposed national macro-prudential measure under Article 458(4) of Regulation (EU) No 575/2013. The proposed measure would enter into force in January 2018.

Following a careful assessment by the Commission services of the conditions which must be met for the adoption of measures under Article 458 of the CRR, the Commission has adopted a Decision in which it has decided not to propose an implementing act under Article 458(4) to reject the proposed national macro-prudential measure. The reasons which led the Commission to reach this conclusion are set out in the Commission Decision which you will find in annex to this letter.

Yours sincerely,

Olivier GUERSENT

Encl.: Commission Decision on not proposing an implementing act to reject draft measure notified by Finland authorities under Article 458 of Regulation (EU) No 575/2013

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EUROPEAN
COMMISSION

Brussels, 21.8.2017
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COMMISSION DECISION

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not to propose an implementing act to reject the proposed national measure notified on 27 June 2017 by Finland under Article 458(4) of Regulation (EU) No 575/2013 of the European Parliament and of the Council

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THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to 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[1], and in particular Article 458 (4) thereof,

Having regard to the opinions of the European Systemic Risk Board[2] and the European Banking Authority[3],

Whereas:

(1) On 27 June 2017, the Finnish Financial Supervisory Authority ("FIN-FSA"), which is the national designated authority in charge of the application of Article 458 of Regulation (EU) No 575/2013, notified the Commission in accordance with Article 458(2) of that Regulation, of its intention to impose a macro-prudential measure to address a macro-prudential risk originating from the Finnish domestic market for residential mortgage loans.

(2) The draft measure consists of introducing an institution-specific minimum level of 15% for the average risk weight on mortgage loans and would apply to credit institutions that have adopted the Internal Ratings Based Approach (IRB approach). The proposed measure would enter into force in January 2018. According to the FIN-FSA the purpose of the draft measure is to target potential asset bubbles in the residential real estate (RRE) sector as referred to in Article 458(2)(d)(vi) of Regulation (EU) No 575/2013 and is intended to mitigate changes in the intensity of systemic risk.

(3) In accordance with Article 458(4) of Regulation (EU) No 575/2013 the European Banking Authority (EBA) and the European Systemic Risk Board (ESRB) shall provide respective opinions on the draft national measure within one month of receiving a notification pursuant to Article 458(2). On 27 July 2017 the Commission received the opinion of the

1 OJ L 176, 27.6.2013, p.1.

2 Opinion of the European Systemic Risk Board of 19 July 2017 on measures in accordance with Article 458 Regulation, (ESRB/2017/3)

3 Opinion of the European Banking Authority on measures in accordance with Article 458 Regulation (EU) No 575/2013 of 27 July 2017 (EBA/Op/2017/10)

EBA ("EBA opinion") and the opinion of the ESRB ("ESRB opinion") on the draft measure.

(4) The FIN-FSA has identified a number of key structural vulnerabilities of the Finnish RRE sector that pose a macro-prudential risk. In particular it has identified historically high household indebtedness, a high share of banks' exposures to housing loans, a low average level of internal ratings-based (IRB) model risk weights, a relatively high dependence of banks on wholesale funding and covered bonds with housing loans serving as collateral. Furthermore, it points to a highly concentrated and interconnected banking sector, which is interlinked with the Nordic financial system which is itself exposed to housing-related risks in other national markets in the region.The FIN-FSA therefore justifies the draft measure as a way to target potential asset bubbles in the residential real estate sector by strengthening the resilience of the banking sector. It furthermore argues that preventive measures need to be taken in the early stages of an asset bubble in order to have a mitigating effect.

(5) As the most important factor affecting the build-up and elevated level of vulnerabilities FIN-FSA emphasises the high indebtedness of the Finnish household sector. At the end of 2016, the debt-to-income ratio of the household sector was 126.9%, compared to 67.5% at the end of 2000. Growth in the stock of housing-related debt relative to households' annual disposable income has been steady since the late 1990s, without significant interruptions and irrespective of the economic cycle.

(6) A number of additional factors are put forward by the FIN-FSA that further illustrates the concerns over household indebtedness in the Finnish mortgage market.

(7) First, structural changes related to the maturity of new housing loans are highlighted. The average length of maturity of new housing loans and the average loan-to-income ratio (LTI) have increased relative to the late 1990s and early 2000s. The average maturity amounted to 19.4 years for new loans (an increase from 18.5 years in April 2015) and to 20.8 years for the stock of loans in April 2017. The average size of new loans is still growing.

(8) Second, the debt and related risks are unevenly distributed among households. More than a quarter (27%) of housing debt is borne by households whose total debt is over four times higher than their annual monetary income. The corresponding figure for 2002 was less than 11%.

(9) Third, high loan-to-value (LTV) ratios at loan origination increase the vulnerability to a risk of falling house prices. According to FIN-FSA, more than 33% of new housing loans in second quarter of 2016 were granted with LTV ratio of above 90% (and in many of these cases the loan exceeded the purchase price). According to the most recent data for the first quarter of 2017, the share of such loans was 41%.

(10) The macro-prudential risk related to household indebtedness in Finland has been noted by number of international institutions, such as the European Systemic Risk Board (ESRB), the Organisation for Economic Co-operation and Development (OECD) and the International Monetary Fund (IMF). According to the ESRB Warning of 22 September

2016[4] ("the ESRB Warning"), Finland faces medium-term vulnerabilities in its residential real estate (RRE) sector. The ESRB Warning states that Finland's vulnerabilities are primarily related to high household indebtedness, with particular implications for the resilience of the banking sector. The risk assessment of the FIN-FSA is in line with the ESRB Warning.

(11) As a result of the in-depth review of the Finnish economy[5], conducted under Article 5 of Regulation[6] (EU) No 1176/2011 and published on 22 February 2017, the Commission concluded that Finland is not experiencing macroeconomic imbalances. Residential real estate prices have been flat or decreased in real terms since 2010 and, in 2016, the price-to-income and price-to-rent ratios are close to their long-term average. Compared to fundamentals, housing prices at the national level do not appear overvalued. Still, regional differences exist, notably with the greater Helsinki region where real estate prices have been increasing relative to the rest of the country. Furthermore, the indebtedness of households has increased strongly since 2000 in a context of sluggish income growth. In view of the facts presented it can be concluded that the draft Finnish measure seeks to increase the resilience of the Finnish banking sector against possible effects of a downturn in the RRE sector and may also indirectly curb excessive mortgage credit growth in the country.

(12) After careful consideration of the evidence provided by the FIN-FSA, the ESRB Warning of 2016 and taking utmost account of the respective opinions of the ESRB and EBA, the Commission agrees that there is evidence suggesting the existence of change in the intensity of macro-prudential risk in the Finnish residential real estate sector. In addition, given the likelihood of an interest rates rise in the foreseeable future, there is a risk of a potential downward correction of prices in the real estate sector, notably as mortgage interest rates in Finland are very low at close to 1.3%. Nonetheless, the Commission considers that the intensity of the risk is in particular linked to over indebtedness of households. This is supported by the ESRB opinion stating that the proposed measure only indirectly addresses the high and increasing level of household indebtedness identified as the main medium term vulnerability in the Finnish RRE sector.

(13) The Commission agrees that the persistent increase and high level of household debt can lead to adverse macro-economic consequences, notably as regards private consumption and investment. In a context of low interest rates, the high share of mortgages with variable rates means that the interest burden for households is contained. However, this could represent a risk going forward as rates are expected to increase in the medium-term. In addition, the Commission recalls recent experiences in other countries, both in the EU and outside which have illustrated how unaddressed RRE risks can entail significant costs for the real economy and can lead to adverse spillover effects to other countries. Given its stated objective to cushion the adverse impacts in the event of a systemic risk materialising, the draft measure should primarily be evaluated against its capacity to enhance resilience to systemic risk. A signalling effect to economic agents would

4 ESRB/2016/08, Warning of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector in Finland.

5 Country Report Finland 2017, including an In-Depth Review on the prevention and correction of macroeconomic imbalances, from 22 February 2017, SWD(2017) 91 final

6 Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances

constitute an additional, indirect benefit of the measure, to the extent that it would help moderate risk-seeking behaviour in lenders and borrowers.

(14) Regarding the potential impact of the measure in addressing these issues, as estimated by the FIN-FSA, six banks applying IRB models and holding approximately 90% of the market for Finnish housing loans will be affected by the measure. There is no supply of housing loans by other financial institutions in Finland. The measure targets residential mortgage loans on properties located in Finland and is applied on a consolidated basis. This represents on average 25% of the affected banks' balance sheets, with the three largest banks accounting for 80% of the total housing loans stock. The FIN-FSA seeks to enhance the resilience of the financial sector by ensuring sufficient capital buffers to cushion credit losses that would be caused by a downturn in the housing market. The overall capital impact of the proposed measure is expected to be around EUR 450 million which equals 1.4 percentage point of the Common Equity Tier 1 (CET1) capital ratio of the affected banks).

(15) The proposed measure complements earlier measures taken by the Finnish authorities to address RRE risks. First, conditions for the maximum LTV ratio for new housing loans have been tightened and entered into force in July 2016. For new mortgage loans LTV limit of 90% and 95% for first-time home buyers were introduced. Second, the tax deductibility of mortgage interest is being progressively reduced from 100% to 25% over the period 2011 to 2019.

(16) Measures under Article 458 of Regulation (EU) No 575/2013, may only be applied where measures under Articles 124 and 164 of Regulation (EU) No 575/2013 and Articles 101, 103, 104, 105, 133, and 136 of Directive 2013/36/EU cannot adequately address the macro-prudential or systemic risk identified, taking into account the relative effectiveness of those measures.

(17) Article 124 of Regulation (EU) No 575/2013 allows the competent authority to set higher values for risk weights of real estate exposures under the standardised approach. Its use would not adequately address the identified systemic risk, since it does not apply to credit institutions that use the IRB approach and which dominate the Finnish market for mortgage loans.

(18) Under Article 164 of Regulation (EU) No 575/2013, the competent authorities can increase the exposure weighted average loss given default (LGD) floor of IRB banks for their retail exposures secured by residential property. The FIN-FSA considers this Article to be inadequate, as it argues that the need for an increase in risk weights for mortgage lending is not related to excessively low LGD values (the average LGD is close to 10%). Furthermore, increasing the LGD floor would have a disproportionate effect on the dispersion of the risk weights of the banks concerned by increasing risk weights for some banks disproportionately. According to the FIN-FSA, this is due to the fact that the IRB risk weight formula is a linear function of the LGD parameter. Therefore, an increase in the LGD floor has a linear (or close to linear) unwanted impact on average risk weights, if banks' initial average LGD level are close to the current floor of 10% (as in Finland). In this way, an increase in LGD floor would have the biggest impact on banks with highest initial average risk weights, leading to a widening of differences between banks. In this respect, the ESRB and EBA concur that a measure under Article 164 would not achieve the intended purpose in the current circumstances.

(19) After examining the arguments and evidence put forward by the FIN-FSA and taking utmost account of the opinions provided by the ESRB and EBA, the Commission considers that measures under Article 124 of Regulation (EU) No 575/2013 currently cannot adequately address the identified specific macro-prudential risk while measures under Article 164 of Regulation (EU) No 575/2013 would not be adequate in the absence of revisions to risk weights underpinned by changes in the internal risk models.

(20) Articles 101, 103 104 and 105 of Directive 2013/36/EU (jointly referred to as Pillar 2[7] measures), allow the competent authority to implement a wide range of supervisory measures to address risks. Furthermore, Article 103 of Directive 2013/36/EU allows the use of Pillar 2 for macro-prudential purposes.

(21) The FIN-FSA argues that Articles 101 of Directive 2013/36/EU cannot adequately address the risk identified, as the banks using internal models following the IRB approach comply with all the requirements of Regulation (EU) No 575/2013 and there appears to be no evidence of a breach of that Regulation. Existing models used for calculating risk weights under the IRB approach ('IRB models') are deemed to be based on micro-prudential statistical data, but do not take into account the additional systemic risk deriving from an overall high level of mortgage lending and household indebtedness. The FIN-FSA further considers that there is no evidence that credit institutions with low average risk weights are underestimating the micro-prudential risks inherent in their exposures. The FIN-FSA notes that the Targeted Review of Internal Models (TRIM) is currently undertaken by the Single Supervisory Mechanism.

(22) The FIN-FSA puts forward arguments why Articles 103 and 104 of Directive 2013/36/EU cannot adequately address the risk identified, namely: (a) capital requirements introduced by the FIN-FSA or ECB based on these Articles apply to individual credit institutions registered in Finland. A large part of the Finnish mortgage market is held by branches of foreign credit institutions (e.g. Nordea, headquarter in Sweden, transformed the major part of its Finnish activities into a branch in early 2017), (b) due to complex coordination among the various supervisors concerned (FIN-FSA, Swedish Finansinspektionen, Danish Finanstilsynet and the European Central Bank (ECB)/Single Supervisory Mechanism and the resulting uncertainty and inconsistency, (c) limited use in practice of Pillar 2 measures for macro-prudential purposes and the fact that the publication of macroprudential measure taken could have a beneficial signaling effect, while the publication of Pillar 2 measures is not mandatory, and (d) challenges regarding a possible recognition[8] of the proposed measure. The Commission concurs with this assessment.

(23) The ESRB opinion reacts to the statement of the FIN-FSA that the micro-prudential risk is not being underestimated and notes that, following a decision by the ECB/ the Single Supervisory Mechanism in early 2016, a major Finnish banking group was required to raise its risk weights for retail exposures following shortcomings observed in the IRB validation process of the models. The ESRB also refers to the fact that the Swedish authorities have taken a different view and imposed a risk weights floor under Pillar 2 on the basis of macro-prudential considerations. The EBA also notes that if the risk weights of

[7] Under the Supervisory Review and Evaluation Process (SREP) the supervisors may ask a bank to hold additional capital and/or set qualitative requirements (usually referred to as "Pillar 2"). It could also refer to the bank's governance structure or its management.

[8] Recommendation ESRB/2015/2 of the European Systemic Risk Board of 15 December 2015 on the assessment of cross-border effects of and voluntary reciprocity for macro-prudential policy measures

Finnish institutions were too low to cover the severe economic crisis regardless of any additional systemic risks, a review of internal models could be an effective measure.

(24) The Commission considers that providing an assessment of the appropriateness of IRB models is beyond the scope of this Decision. The Commission refers to the responsibility of the FIN-FSA and other supervisors in their capacity as micro-prudential supervisors to review the adequacy of the internal models. Furthermore, and in line with the ESRB and EBA opinions, the Commission considers that the targeted review of internal models, which is expected to deliver the first results in 2018, could give rise to recalibrations of internal models, for instance with respect to the impacts of a price fall similar to the one during the Finnish financial crisis of the 1990s in the presence of the current higher household debt ratio and as regards the impact of second-round effects. This would in turn require a recalibration of the proposed measure. The Commission underlines the importance of tracing IRB model deficiencies and confirms the need to ensure a consistent approach to calibrating housing loan risk weights in Finland. Coordination across all supervisory authorities involved may be challenging, however, it is important to ensure appropriate housing loan risk weights in Finland.

(25) Article 105 of Directive 2013/36/EU allows competent authorities to impose specific liquidity requirements if it is deemed necessary to capture liquidity risks to which an institution is or might be exposed. The systemic risk the FIN-FSA aims to tackle with the draft measure is not linked to credit institutions’ liquidity risk. Hence, the Commission considers that Article 105 of that Directive is not suitable to address the identified risk.

(26) After examining the arguments and evidence put forward by the FIN-FSA and taking utmost account of the opinions provided by the ESRB and EBA, the Commission is of the opinion that measures under Articles 101, 103, 104 and 105 of Directive 2013/36/EU would currently not be adequate, as their application would not be effective in addressing the identified specific macro-prudential risk.

(27) Under Article 133 of Directive 2013/36/EU Member States may introduce a systemic risk buffer to address long-term non-cyclical systemic or macro-prudential risks not covered by Regulation (EU) No 575/2013. The systemic risk buffer can be applied to all banks or to a subset of banks. In the case of Finland, the Commission agrees with the classification of the main systemic risk as structural rather than cyclical.

(28) The FIN-FSA notes that the systemic risk buffer cannot be put in place in the near future as it is currently not available under Finnish legislation. The Ministry of Finance is in the process of compiling a legislative proposal on adopting the systemic risk buffer as a macro-prudential instrument, to be submitted to the Finnish Parliament. The timetable and outcome of this process are uncertain, however. The Finnish authorities indicate that the use of the systemic risk buffer would be considered when the current proposed measure is reviewed in 2019. The Commission takes note of current steps towards the implementation into national law of the systemic risk buffer. In its opinion the EBA also states that the introduction of a systemic risk buffer could be more efficient than the proposed measure, as well as fully transparent. The EBA concludes that if the systemic risk buffer is implemented in national legislation and available to the FIN-FSA, the situation should be reassessed.

(29) The countercyclical buffer (CCyB) referred to in Article 136 of Directive 2013/36/EU, is an instrument which targets cyclical developments, whereas the main risk identified by the FIN-FSA is rather of a structural nature and pertains to the risks associated with the high

level of household debt. FIN-FSA notes that there is no sign of excessive credit growth in the short and medium term, as for example reflected in the credit gap. Moreover, similar to the systemic risk buffer, the countercyclical buffer applies to all non-financial exposures located in a jurisdiction and, thus, would not be targeted to exposures in the residential real estate sector only, as is the case for the proposed measure. Hence this measure would not appropriately target the risk identified by the FIN-FSA, as it would also affect exposures towards SMEs, households and non-financial corporates. The Commission also notes that the countercyclical buffer rate is applicable to the whole banking system of the Member State concerned and cannot be narrowed down to a subset of institutions, such as banks having adopted the IRB approach.

(30) After examining the arguments and evidence put forward by the FIN-FSA and taking utmost account of the opinions provided by the ESRB and EBA, the Commission notes that the systemic risk buffer is not available in the short term and acknowledges that the countercyclical buffer cannot adequately address the identified specific macro-prudential risk. The Commission welcomes steps recently undertaken by the Finnish authorities to ensure the availability of the systemic risk buffer in the Finnish legislation. Concurring with the ESRB opinion, the Commission also notes that, since the measure under Article 458 is of a temporary nature, the Finnish authorities could consider to retain the systemic risk buffer when the measure is revised in 2019.

(31) After carefully considering the opinions of the ESRB and the EBA, the Commission concludes that the draft measure is suitable, effective and proportionate under the current circumstances in addressing the systemic risk identified by the FIN-FSA. The draft measure proposed is also less ineffective than the alternative available measures to be considered in accordance with Article 458(2)(c) of Regulation (EU) No 575/2013. However the Commission notes that the systemic risk buffer which has not been implemented in national legislation and the borrower-based macro-prudential measures (income-based instruments as loan-to-income, debt-to-income and debt service-to-income), which are currently not available in Finland, could have been used to mitigate the change in intensity of risk.

(32) The Commission also notes the issues raised by the ESRB and EBA in their opinions and agrees that they require appropriate follow up. In particular, the Commission underlines the relevance of tracing possible deficiencies of IRB models and emphasises the importance of ensuring a consistent approach to determining risk weights for housing loans in Finland. The Commission stresses that close coordination across all supervisory authorities involved is important to ensure that risk weights for housing loan in Finland are appropriate.

(33) Concerning cross-border effects of the draft measure, data provided by the FIN-FSA shows that while foreign branches account for a non-negligible share of the market of bank mortgage lending to Finnish households, foreign banks in some Member States are already subject to additional (earmarked) capital requirements imposed on Finnish housing loans exposures by their home supervisors. The share of direct cross-border lending and the role of non-banks in the Finnish housing loan market are reported to be negligible. Moreover, there is only a marginal expected impact of the measure on banks' funding costs and loan margins.

(34) The Commission notes the request by the FIN-FSA to the ESRB to recommend to other Member States to recognise and reciprocate the measure, as their banking sector may be

exposed directly or indirectly (through branches) to the risk related to the residential real estate sector in Finland.

(35) Regarding the likely impact of the draft measure on the internal market, the FIN-FSA notes that given the measure's scope and nature, the probability of inward spillovers (in the form of leakages and regulatory arbitrage) and outward spillovers (cross-border effects of the measure on other Member States) is limited. Overall, the Commission concurs with this assessment and does not expect the draft measure to have a negative impact on the internal market that would outweigh its financial stability benefit, namely a more resilient Finnish banking sector. The draft measure aims at strengthening the resilience of the Finnish banking system against potential effects of a shock in the Finnish real estate sector which should reduce the potential contagion channels to other Member States. This is also in line with the ESRB's and EBA's assessment that the draft measure would not entail disproportionate adverse effect for the internal market or other national financial systems.

(36) The Commission, after taking utmost account of the opinions of the ESRB and the EBA, concludes, on the basis of its assessment, that there is robust, strong and detailed evidence that the measure proposed by the FIN-FSA will not have a negative impact on the internal market that outweighs the financial stability benefits resulting in a reduction of the macro-prudential or systemic risk identified. Nevertheless, the Commission notes the importance for the macro-prudential authorities to closely monitor the development of mortgage lending through direct cross-border lending or branches, as well as any changes in corporate structures of the relevant Nordic banking groups.

HAS DECIDED AS FOLLOWS:

Sole Article

The Commission does not propose to the Council an implementing act to reject the proposed national measure notified on 27 June 2017 by the Republic of Finland in accordance with Article 458(4) of Regulation (EU) No 575/2013 of the European Parliament and of the Council.

Done at Brussels, 21.8.2017

For the Commission
Valdis Dombrovskis
Member of the Commission