RECOMMENDATION OF THE EUROPEAN SYSTEMIC RISK BOARD

of 27 June 2019

on medium-term vulnerabilities in the residential real estate sector in the Netherlands

(ESRB/2019/7)

THE GENERAL BOARD OF THE EUROPEAN SYSTEMIC RISK BOARD,

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

Having regard to Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board[1], and in particular Articles 3, 16, 17 and 18 thereof,

Whereas:

(1) The real estate sector plays an important role in the economy and its developments may have a material influence on the financial system. Past financial crises have demonstrated that unsustainable developments in real estate markets may have severe repercussions on the stability of the financial system and of the economy as a whole, which may also lead to negative cross-border spillovers. Adverse real estate market developments in some Member States have, in the past, resulted in large credit losses and/or had a negative impact on the real economy. Such effects reflect the close interplay between the real estate sector, funding providers and other economic sectors. Furthermore, the strong feedback loops between the financial system and the real economy reinforce any negative developments.

(2) These links are important because they mean that risks originating in the real estate sector may have a systemic impact that is procyclical in nature. Financial system vulnerabilities tend to accumulate during the upswing phase of the real estate cycle. The perceived lower risks of, and easier access to, funding may contribute to a rapid expansion of credit and investment, together with an increased demand for real estate, which puts upward pressure on property prices. Since the resulting higher collateral values further favour the demand for, and supply of, credit, these self-reinforcing dynamics may result in potential systemic consequences. Conversely, during the downturn phase of the real estate cycle, tighter credit conditions, higher risk aversion and downward pressure on real estate prices may adversely affect the resilience of borrowers and lenders, thereby weakening economic conditions.

(3) Vulnerabilities relating to residential real estate can be a source of systemic risk and they may affect financial stability both directly and indirectly. Direct effects are for credit losses on mortgage portfolios due to adverse economic or financial conditions and simultaneous

1 OJ L 331, 15.12.2010, p. 1.

negative developments in the residential real estate market. Indirect effects could be related to adjustments in household consumption, leading to further consequences for the real economy and financial stability.

(4) As stated in recital 4 of Recommendation ESRB/2013/1[2], the ultimate objective of macroprudential policy is to contribute to the safeguard of the stability of the financial system as a whole, including by strengthening the resilience of the financial system and decreasing the build-up of systemic risks, thereby ensuring a sustainable contribution of the financial sector to economic growth.

(5) To this end, macroprudential authorities may use one or more of the capital-based macroprudential measures set out in Directive 2013/36/EU of the European Parliament and of the Council[3] and Regulation (EU) No 575/2013 of the European Parliament and of the Council[4], and/or borrower-based macroprudential measures, which are exclusively based on national law, depending on the assessment of risks. While the capital-based measures are primarily aimed at increasing the resilience of the financial system, the borrower-based measures may be particularly suitable for preventing the further build-up of systemic risks.

(6) In addition, Recommendation ESRB/2013/1 recommends that Member States establish a legal framework that permits the macroprudential authorities to have direct control or recommendation powers over the macroprudential instruments identified in that Recommendation.

(7) In 2016, the European Systemic Risk Board (ESRB) conducted a Union-wide assessment of the vulnerabilities relating to residential real estate[5]. This assessment enabled the ESRB to identity a number of medium-term vulnerabilities in several countries as sources of systemic risk to financial stability, which led to the issuance of warnings to eight countries, of which the Netherlands was one[6].

(8) In 2016 the main vulnerability identified in the residential real estate market in the Netherlands related to high household indebtedness, with a significant share of mortgagors having total debt exceeding the value of their home. This vulnerability reflected, among other things, that although the share of new amortising mortgage loans was increasing, a significant share of the existing mortgage loans was non-amortising – despite the fact that in

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2 Recommendation ESRB/2013/1 of the European Systemic Risk Board of 4 April 2013 on intermediate objectives and instruments of macro-prudential policy (OJ C 170, 15.6.2013, p. 1).

3 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 and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

4 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).

5 See 'Vulnerabilities in the EU Residential Real Estate Sector', ESRB, November 2016, available on the ESRB's website at www.esrb.europa.eu.

6 Warning ESRB/2016/10 of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of Netherlands (OJ C 31, 31.1.2017, p. 53).

2016 there were no signs of overvaluation and house prices in major cities were returning to pre-crisis levels.

(9) The ESRB has recently concluded a systematic and forward-looking European Economic Area (EEA)-wide assessment of vulnerabilities relating to residential real estate[7].

(10) As regards the Netherlands, this recent assessment has revealed that, since 2016, household indebtedness has decreased slightly and the share of new non-amortising mortgage loans has also continued to decrease. On the other hand, since 2016, house prices have continued to increase, leading to pockets of overvaluation in the major cities. Against this background, the loan-to-value (LTV) ratios of new mortgage loans have remained high, in particular because the regulatory limit of 100 % that applies to the LTV ratio does not require additional collateral for an event of a decrease in house prices. The vulnerabilities posed by these developments with regard to financial stability have not been reflected in the application of risk weights for mortgage loans in the Netherlands, which are among the lowest in the EEA.

(11) Since 2016, the gradual tightening of the legally-binding limit that applies to the LTV ratio continued, and it was lowered to 100 % in 2018 (from 106 % in 2012). In 2018, the Dutch Government also announced that it would gradually reduce the maximum rate at which interest paid on mortgage loans can be deducted, from 49.5 % in 2018 to around 37 % in 2023.

(12) Even though the macroprudential authority in the Netherlands (Financieel Stabiliteitscomité) has recommended a further tightening of the legally binding limit that applies to the LTV ratio to 90 %, the Dutch Government, which is responsible for implementing such measures, has chosen not to follow this recommendation. Furthermore, since the current legal framework does not provide for an 'act or explain' mechanism for recommendations made by the macroprudential authority, the Dutch Government has not been formally required to explain its inaction to the macroprudential authority, but has only explained its position to the Dutch Parliament. However, in order to address the vulnerabilities identified in the Netherlands as regards pockets of overvaluation of house prices and the collateralisation of new mortgage loans, the limit that applies to the LTV ratio would need to be reduced. Moreover, there are no macroprudential capital-based measures – for example higher risk weights for mortgage loans – currently in place to address the accumulated vulnerabilities related to the collateralisation of existing mortgage loans and the potential second-round effects related to household indebtedness.

(13) Although the debt-service-to-income (DSTI) ratio for mortgage loans has important risk mitigating characteristics, such as assumptions about potential increases in interest rates, certain elements of the current methodology for calibrating the limit that applies to the DSTI ratio in the Netherlands reduce the effectiveness of the measure and may increase its procyclical effects on the financial and economic cycles. While some adjustments (such as the use of four-year averages of the calculated ratios as inputs for the calibration) have been

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7 See 'Vulnerabilities in the residential real estate sectors of EEA countries', ESRB, 2019, available on the ESRB's website at www.esrb.europa.eu.

made to address the procyclical elements of the methodology, certain of these elements remain.

(14) While cyclical factors play an important role in fuelling the vulnerabilities identified in the Netherlands, there are also structural factors that have driven these vulnerabilities, resulting in a higher level of systemic risk. These factors include: (i) a lack of housing supply, which has been exerting upward pressure on house prices and debt for households that buy their own property; and (ii) the tax deductibility of interest paid on mortgage loans, which may act as an incentive for households to overborrow.

(15) Therefore, the ESRB has concluded that the macroprudential measures that are in place in the Netherlands are partially appropriate and partially sufficient to address the vulnerabilities related to household indebtedness in the medium term. Consequently, further policy action is required to address these vulnerabilities, which can be a source of systemic risk. The measures proposed in this Recommendation are aimed at complementing the existing macroprudential measures in the Netherlands.

(16) Given that the vulnerabilities are, to some extent, driven by structural factors which go beyond macroprudential policy, other policies are needed to complement and support the current macroprudential measures, with the aim of addressing factors contributing to the build-up of systemic risks in the residential real estate market in the Netherlands more efficiently and effectively, without producing excessive costs for the Dutch real economy and financial system.

(17) The purpose of this Recommendation is to recommend: a) the establishment in Dutch law of an 'act or explain' mechanism in relation to recommendations issued by the macroprudential authority on the activation of legally binding borrower-based measures; (b) the tightening of the existing legally binding limit that applies to the LTV ratio; (c) an amendment to the methodology for determining the maximum limit that applies to the DSTI ratio; and (d) the activation of capital-based measures in order to ensure the resilience of the banking sector in relation to the medium-term vulnerabilities identified in the Netherlands. This Recommendation also aims to emphasise the need for broader policy action aiming to curb factors which facilitate or promote increasing household indebtedness.

(18) This Recommendation is without prejudice to the monetary policy mandates of the central banks in the Union.

(19) ESRB recommendations are published after the General Board has informed the Council of the European Union of its intention to do so and provided the Council with an opportunity to react, and after the addressees have been informed of the intention to publish,

HAS ADOPTED THIS RECOMMENDATION:

SECTION 1

RECOMMENDATIONS

Recommendation A – Legal framework for borrower-based measures

It is recommended that the Netherlands ensure that the recommendation powers of the macroprudential authority over all applicable legally binding borrower-based measures are complemented by an 'act or explain' mechanism, or alternatively, where this is not possible under Dutch law, that an accountability mechanism is established in order to make public the views of the authority responsible for the application of borrower-based measures following a recommendation issued by the macroprudential authority in the Netherlands.

Recommendation B – Tightening of borrower-based measures and approach to calibration

1. It is recommended that the Netherlands lower the current legally binding limit that applies to the LTV ratio, thus ensuring that collateral for new mortgage loans is sufficient to cover credit losses corresponding to the potential decrease in house prices under adverse economic or financial conditions.
2. It is recommended that the Netherlands change the methodology for determining the maximum limit that applies to the DSTI ratio so that the measure does not lead to increasing procyclicality of the economic and financial cycles.

Recommendation C – Activation of capital-based measures

It is recommended that the macroprudential authority, the designated authority or the competent authority in the Netherlands, as applicable, ensure, by activating capital-based measures, the resilience of credit institutions authorised in the Netherlands in the face of the potential materialisation of systemic risk related to residential real estate which could lead to direct and indirect credit losses stemming from mortgage loans or arising as a consequence of the decrease in consumption by households with housing loans.

Recommendation D – Structural changes related to mortgage loans and the residential real estate sector

It is recommended that the Netherlands review its policies with the aim of curbing the structural factors that have driven the vulnerabilities identified in the Netherlands as a source of systemic risk and which provide incentives for households to take on excessive mortgage debt, or cause excessive growth in house prices and mortgage debt.

SECTION 2

IMPLEMENTATION

1. Definitions

For the purposes of this Recommendation the following definitions apply:

(a) 'borrower-based measures' means macroprudential measures that target borrowers;

(b) 'direct control' means a real and effective capacity to impose and modify, where necessary to achieve an ultimate or intermediate objective, macroprudential measures applicable to the financial institutions that are under the scope of action of the corresponding macroprudential authority;

(c) 'recommendation powers' means the capacity to guide, by means of recommendations, the application of macroprudential instruments, where necessary to achieve an ultimate or intermediate objective;

(d) 'loan-to-value ratio' (LTV ratio) means the sum of all loans or loan tranches secured by the borrower on the immovable property at the moment of loan origination relative to the value of the property at the moment of the loan origination;

(e) 'macroprudential authority' means a national macroprudential authority with the objectives, arrangements, powers, accountability requirements and other characteristics set out in Recommendation ESRB/2011/3[8];

(f) 'debt-service' means the combined interest and principal repayment on a borrower's total debt over a given period (generally one year);

(g) 'debt-service-to-income ratio' (DSTI ratio) means the annual total debt service relative to the borrower's total annual disposable income at the moment of loan origination;

(h) 'medium term' means within a three-year horizon;

(i) 'legally binding borrower-based measures' means borrower-based measures that are introduced through legally binding acts.

2. Criteria for implementation

1. The following criteria apply to the implementation of this Recommendation:

(a) due regard should be given to the principle of proportionality, taking into account the objective and content of Recommendation A, Recommendation B, Recommendation C and Recommendation D;

(b) when lowering the existing limit that applies to the LTV ratio under Recommendation B, the calibration and phasing-in of the measure should take into account the position of the Netherlands in the economic and financial cycles, and any potential implications as regards the associated costs and benefits;

(c) when activating capital-based measures under Recommendation C, their calibration and phasing-in should take into account the position of the Netherlands in the economic and financial cycles, and any potential implications as regards the associated costs and benefits;

(d) as regards Recommendation D, when making policy changes, the phasing-in of such measures should take into account the position of the Netherlands in the economic and financial cycles, so that these measures do not serve to amplify or trigger the

8 Recommendation ESRB/2011/3 of the European Systemic Risk Board of 22 December 2011 on the macro-prudential mandate of national authorities (OJ C 41, 14.2.2012, p. 1).

materialisation of accumulated vulnerabilities in the residential real estate sector in the Netherlands;

(e) specific criteria for compliance with Recommendation B, with Recommendation C and with Recommendation D are set out in Annex I.

2. The addressees of this Recommendation are requested to report to the ESRB and to the Council on the actions undertaken in response to this Recommendation, or adequately justify any inaction. The reports should as a minimum contain:

(a) information on the substance and timeline of the actions undertaken;

(b) an assessment of the vulnerabilities related to pockets of overvaluation of house prices and the collateralisation of new and existing mortgage loans, including the distribution of new mortgage loans according to their LTV ratios, with the relevant ratios being calculated in accordance with Annex IV to Recommendation ESRB/2016/14 of the European Systemic Risk Board[9], together with the functioning of the actions undertaken, having regard to the objectives of this Recommendation;

(c) a detailed justification of any inaction or departure from this Recommendation, including any delays.

3. Timeline for the follow-up

The addressees of this Recommendation are requested to report to the ESRB and to the Council on the actions taken in response to this Recommendation, or adequately justify any inaction, in compliance with the following timelines:

(a) *Recommendation A*

By 31 March 2021, the addressee of Recommendation A is requested to submit a final report to the ESRB and to the Council on the implementation of Recommendation A.

(b) *Recommendation B*

By 31 October 2020, and yearly thereafter until 31 October 2022, the addressee of Recommendation B(1) is requested to submit to the ESRB and to the Council a report on any actions taken with regard to tightening borrower-based measures. Where there is more than one body responsible for taking actions to address the vulnerabilities identified, one joint report should be submitted.

By 31 March 2021, the addressee of Recommendation B(2) is requested to submit to the ESRB and to the Council a report on the implementation of Recommendation B(2). Where there is more than one body responsible for taking actions to address the vulnerabilities identified, one joint report should be submitted.

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9 Recommendation ESRB/2016/14 of the European Systemic Risk Board of 31 October 2016 on closing real estate data gaps (OJ C 31, 31.1.2017, p. 1).

(c) *Recommendation C*

By 31 October 2020, and yearly thereafter until 31 October 2022, the addressees of Recommendation C are requested to submit to the ESRB and to the Council a report on any actions taken with regard to implementing capital-based measures. Where there is more than one body responsible for taking actions to address the vulnerabilities identified, one joint report should be submitted.

(d) *Recommendation D*

By 31 October 2022, the addressee of Recommendation D is requested to submit to the ESRB and to the Council a report on the implementation of Recommendation D. Where there is more than one body responsible for taking actions to address the vulnerabilities identified, one joint report should be submitted.

4. Monitoring and assessment

1. The ESRB Secretariat will:

   (a) assist the addressees, ensuring the coordination of reporting, the provision of relevant templates and detailing, where necessary, the procedure and the timeline for the follow-up;

   (b) verify the follow-up by the addressees, provide assistance at their request, and submit follow-up reports to the General Board. Three assessments will be initiated as follows:

   (i) by 31 December 2020, regarding the implementation of sub-recommendation B(1) and Recommendation C;

   (ii) by 31 December 2021, regarding the implementation of Recommendations A, sub-recommendations B(1) and B(2) and Recommendation C;

   (iii) by 31 December 2022 regarding the implementation of subrecommendation B(1)and Recommendations C and D.

2. The General Board will assess the actions and justifications reported by the addressees and, where appropriate, may decide that this Recommendation has not been followed and that an addressee has failed to provide adequate justification for its inaction.

Done at Frankfurt am Main, 27 June 2019.

Francesco Mazzaferro

Head of the ESRB Secretariat, on behalf of the General Board of the ESRB

Francesco MAZZAFERRO

ANNEX I

SPECIFICATION OF COMPLIANCE CRITERIA APPLICABLE TO THE RECOMMENDATIONS

Recommendation B – Tightening of, and approach to calibrating, borrower-based measures

The following compliance criterion is applicable to sub-recommendation B(1).

Prior to further lowering the existing limits that apply to the loan-to-value (LTV) ratio, an assessment should be made of the position of the Netherlands in the economic and financial cycles in order to determine an appropriate calibration and phasing-in of such measures.

The following compliance criterion is applicable to sub-recommendation B(2).

When calibrating the limit that applies to the DSTI ratio, the Netherlands should assess the potential procyclical effects of different elements of the methodology used for the calibration.

Recommendation C – Activation of capital-based measures

The following compliance criteria are applicable to Recommendation C.

1. Prior to activating capital-based measures, an assessment should be made of the position of the Netherlands in the economic and financial cycles in order to determine whether activating such measures would be appropriate.
2. After the activation of the capital-based measures, their further tightening or the activation of additional macroprudential measures may be needed to address the vulnerabilities identified in the Netherlands; this will depend on the choice of the capital-based measures activated, on the initial calibration of those measures and on the results of the assessment of vulnerabilities.

Recommendation D – Structural changes related to mortgage loans and the residential real estate sector

The following compliance criterion is applicable to Recommendation D.

When formulating policy options, and before implementing any policy changes, an assessment should be made of the impact of the proposed measures considering the position of the Netherlands in the economic and financial cycles, to ensure that such measures do not amplify or trigger the materialisation of the accumulated vulnerabilities in the residential real estate sector in the Netherlands.