EBA/CP/2015/12

6 July 2015

Consultation Paper

Draft Regulatory Technical Standards on the conditions that competent authorities shall take into account when determining higher risk-weights, in particular the term of "financial stability considerations" under Article 124(4)(b) CRR and the conditions that competent authorities shall take into account when determining higher minimum LGD values under Article 164(6) CRR

Contents

1. Responding to this Consultation

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions summarised in 5.2.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 06.10.2015. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EC) N° 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the EBA in its implementing rules adopted by its Management Board. Further information on data protection can be found under the Legal notice section of the EBA website.

2. Executive Summary

This consultation paper (CP) for these draft regulatory technical standards (RTS) sets out the conditions that competent authorities shall take into account when determining higher risk-weights for exposures secured by immovable property, in particular the term of "*financial stability considerations*", and hence affect the capital requirements for banks applying the Standardised Approach (SA) to those exposures (Article 124(4)(b) CRR). Similarly, this CP for these draft RTS sets out the conditions that competent authorities shall take into account when increasing the minimum exposure weighted loss given default (LGD) for retail exposures secured by residential or commercial immovable property, hence affecting the capital requirements of banks applying the Internal Ratings Based (IRB) approach to those exposures (Article 164(6) CRR). Given the similar nature of the mandate in both Articles 124 and 164 CRR, these conditions are specified jointly in the CP for these draft RTS.

For banks applying the SA, the CRR specifies the preferential risk weight of 35% for exposures fully and completely secured by mortgages on residential property and 50% for exposures fully and completely secured by mortgages on immovable property. Competent authorities may however, under the conditions which are specified in this CP for these draft RTS, increase the risk weights for these exposures, or a segment of those exposures, up to 150%, on the basis of the loss experience, forward-looking immovable property market developments and financial stability considerations. This should ensure that when a high level of credit risk is identified in the real sector and in particular in these exposures or the build-up of a real estate bubble is identified and is expected to lead to increased losses on those exposures, competent authorities increase the capital requirements for such exposures when there are financial stability considerations.

For banks applying IRB models for the calculation of capital requirements for those exposures, the applied risk weight is a result of the applicable risk parameters: probability of default (PD), exposure at default (EAD) and LGD. Whereas the minimum LGD floor for such exposures is set in the CRR (10% for retail exposures secured by residential property and 15% for retail exposures secured by commercial immovable property), competent authorities may, under the conditions which are specified in the CP for these draft RTS, increase the LGD floors for these exposures on the basis of the loss experience, forward-looking immovable property market developments and financial stability considerations.

Competent authorities should frequently and at least annually assess whether the risk weights and minimum LGD values of (retail) exposures secured by mortgages on residential or commercial property are appropriate for the actual risks of these portfolios. This CP for these draft RTS specify that when competent authorities set higher risk weights or LGD floors to immovable property exposures in the jurisdiction of the competent authority, they should take three sets of conditions into account, which relate to (i) the assessment of the appropriateness of the risk weights or LGD floors (ii) the financial stability considerations, and (iii) other conditions.

In order to promote consistency in the setting of higher risk weights, this CP for these draft RTS specify that competent authorities determine the level of observed losses associated with exposures fully and completely secured by immovable property, as well as the level of losses which they expect to be realised on the basis of forward-looking immovable property market developments. As such, all indications of risk related to these exposures, both backward-looking and forward-looking, should be taken into account. Similarly, it is specified that competent authorities should determine the observed level of exposure weighted average LGDs for these exposures, as well as the exposure weighted average LGD which they expect to be realised on these exposures based on a forward-looking assessment.

Given the direct relationship between losses and risk weights for capital requirements, this CP consults on indicative benchmarks which aim to provide further guidance to the setting of higher risk weights by competent authorities, and in particular on the appropriate level set in these indicative benchmarks.

Finally, financial stability considerations are specified in this CP for these draft RTS as three possible scenarios which indicate that refraining from setting higher risk weights or higher minimum LGD values would have a material impact on the current or future stability of the financial system because of a significant decline in resilience of the financial system or a material disruption in the flow of lending to the economy.

3. Background and rationale

Article 124(4)(b) CRR mentions the EBA mandate to 'specify the conditions that competent authorities shall take into account when determining higher risk-weights, in particular the term of "financial stability considerations"'. Furthermore, Article 164(6) CRR mentions the EBA mandate to specify the conditions that competent authorities shall take into account when determining higher minimum LGD values'.

When considering Articles 124 and 164 CRR together, it can be noticed that both mandates have many similarities, which is why this CP for these draft RTS specify these conditions jointly in one RTS. More specifically, Articles 124(4)(b) and 164(6) CRR mandate EBA to specify through regulatory technical standards (delivery date 31 December 2014), the conditions that competent authorities have to take into account when:

- increasing up to 150% the preferential risk weights for exposures secured by mortgages on immovable property under the Standardized Approach: 35% for Residential Real Estate (RRE) and 50% for Commercial Real Estate (CRE);

- increasing the minimum value of exposure weighted LGD for retail exposures secured by immovable property under the IRB approach: 10% for RRE, 15% for CRE.

Articles 124 and 164 CRR furthermore require, that competent authorities shall make these adjustments where appropriate, on the basis of “financial stability considerations”, and that competent authorities shall periodically and at least annually assess whether the risk weights and minimum LGD values of exposures secured by mortgages on RRE or CRE located in one or more parts of its territory are appropriate and reflect the actual risks based on the loss experience of such exposures and the forward-looking immovable property market developments. As such, the three elements of (i) financial stability considerations, (ii) loss experience, and (iii) forward-looking property developments, are relevant for making adjustments to the risk weights or minimum LGD values of immovable property located in the jurisdiction of the competent authority.

This CP for the draft RTS specifies that when competent authorities set higher risk weights or LGD floors to immovable property exposures in the jurisdiction of the competent authority, they should take three sets of conditions into account, which relate to (i) the assessment of the appropriateness of the risk weights or LGD floors (ii) the financial stability considerations, and (iii) other conditions.

As regards the assessment of the appropriateness of RWs or LGD floors, this CP requires competent authorities to determine the loss experience and loss expectation when setting higher RWs and the observed LGD and LGD expectation when setting higher LGD floors. In order to allow that national specificities in immovable property markets across the EU can be taken into account, the conditions to be taken into account by the competent authority when setting higher RWs or LGD floors are flexible. In particular, the CP specifies that competent authorities should make adjustments to the loss experience or observed LGD on the basis of forward-looking immovable property market developments, among others driven by the historical and expected evolution in immovable property market prices and its volatility, the fundamental drivers in demand and supply and the structural and cyclical characteristics of the immovable property market. This approach promotes an integrated assessment of both backward-looking and forward-looking drivers of risk related to these exposures fully and completely secured by mortgages immovable property.

Given the direct relationship between losses and risk weights for capital requirements, this CP consults on indicative benchmarks which aim to provide further guidance to the setting of higher risk weights by competent authorities, and in particular on the appropriate level set in these indicative benchmarks.

As regards the other conditions, this CP specifies that competent authorities should provide an explanation as to why the risk weights and LGD values are increased in a way that ensures correspondence between the higher risk weight or LGD value and the loss or LGD expectation related to these exposures. As such, financial stability considerations are a necessary condition for setting higher risk weights or LGD floors, but the loss or LGD expectation should determine the level of the higher RWs or LGD floors. When setting higher risk weights or LGD values, competent authorities should provide an explanation as to why increasing the RWs or LGD floors is deemed to mitigate the financial stability considerations.

Finally, financial stability considerations are specified in this CP for these draft RTS as three possible scenarios which indicate that refraining from setting higher risk weights or higher minimum LGD values would have a material impact on the current or future stability of the financial system because of a significant decline in resilience of the financial system or a material disruption in the flow of lending to the economy.

Pursuant to Articles 124(5) and 164(7) CRR, mandatory reciprocity is connected to all changes applied to the risk weights, criteria or minimum LGD values which are applied by the competent authorities of all Member States. This means in particular that institutions of all Member States have to apply the risk weights, criteria and minimum LGD values which have been determined by the competent authority of other Member States. This mandatory reciprocity ensures that the same amount of capital requirements is set for exposures secured by immovable property located in the same Member State, and hence contributes to preserving the EU single market. In setting these higher risk weights or higher minimum LGD values, it is therefore important to ensure consistency, i.e. to ensure that the same capital requirements are connected to the same level of risk on these exposures.

In line with the mandate mentioned in Article 124(2) and Article 164(5) CRR, EBA publishes the adjustments to the risk weights and the stricter criteria on which EBA has been consulted and the minimum values of exposure weighted LGD of which EBA has been notified on its website[1]. This ensures that institutions in all Member States can apply the higher risk weights, stricter criteria or higher minimum LGD values which have been determined by the competent authorities.

[1] http://www.eba.europa.eu/supervisory-convergence/supervisory-disclosure/rules-and-guidance

4. Draft Regulatory TS on the conditions that competent authorities shall take into account when determining higher risk-weights and higher minimum LGD values

COMMISSION DELEGATED REGULATION (EU) No …/..
of XXX
supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to the conditions for competent authorities when setting higher risk weights and higher minimum LGD values

(Text with EEA relevance)

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[2], and in particular Article 124(4)(b) and Article 164(6) thereof,

Whereas:

(1) The provisions in this Regulation are closely linked, since they deal with the determination of higher values for parameters that are inputs to the own funds calcuation relating to immovable property, namely the determination of higher risk weights in accordance with Article 124(4)(b) of Regulation (EU) 575/2013 and higher minimum LGD values in accordance with Article 164(4)(a) of that Regulation. To ensure coherence between those provisions, which should enter into force at the same time, and to facilitate a comprehensive view and compact access to them by the addressees of those obligations and interested or affected parties, it is desirable to include both sets of the relevant regulatory technical standards required by Regulation (EU) No 575/2013 in a single Regulation.

[2] OJ L 176, 27.6.2013, p. 1.

(2) For the purpose of ensuring consistency in the setting of higher risk weights and preserving the EU single market related to the mandatory reciprocity referred to in Article 124(4) of Regulation (EU) 575/2013, whereby the adjustments to the risk weights and criteria applied referred to in Articles 125 or 126 of that Regulation to one or several segments of these exposures determined by the competent authority in one Member State should be applied by the institutions of all other Member States, this Regulation specifies conditions for the assessment of the appropriateness of the risk weights, financial stability considerations and other conditions for setting higher risk weights.

(3) For the purpose of ensuring consistency in the setting of higher minimum LGD values in the EU single market, this Regulation specifies conditions for the assessment of the appropriateness of the minimum LGD values, financial stability considerations and other conditions for setting higher minimum LGD values.

(4) This Regulation specifies that the term of financial stability considerations should be understood as one of three scenarios that indicate that refraining from setting higher risk weights or higher minimum LGD values would have a material impact on the current or future stability of the financial system because of a significant decline in resilience of the financial system or a material disruption in the flow of lending to the economy. When setting higher risk weights or minimum LGD values, competent authorities should provide an explanation as to why increasing the risk weights or minimum LGD values is deemed to mitigate the financial stability considerations.

(5) For the purpose of ensuring consistency in the assessment of the appropriateness of risk weights and minimum LGD values across jurisdictions, this Regulation specifies which information should be taken into account when making adjustments to the loss experience and reported exposure weighted LGD values on the basis of forward-looking immovable property market developments.

(6) In order to promote prudence in the setting of higher risk weights or LGD values, this Regulation specifies that the competent authority may be more conservative in its assessment of the loss or LGD expectation when there is more uncertainty about the expected evolution in immovable property market prices or the expected volatility in those prices or when certain data indicators are not available over a sufficiently long period.

(7) Since the adjustments to the risk weights and criteria applied referred to in Articles 125 or 126 of Regulation (EU) No 575/2013 to one or several segments of these exposures determined by the competent authority in one Member State should be applied by the institutions of all other Member States, this Regulation specifies that when a competent authority sets a higher risk weight to one or more property segments, it should provide a clear definition of the property segment and the property segment should be a homogenous group of exposures of a significant size.

(8) In order to ensure that higher risk weights and higher minimum LGD values are appropriate for the actual risk of these portfolios, this Regulation specifies that competent authorities should provide an explanation as to why the risk weights or LGD

values are increased in a way that ensures correspondence between the higher risk weight and the loss expectation or the higher minimum LGD value and the LGD expectation related to these exposures.

(9) The specificities of national immovable properties and the risks for the stability of the financial system should be thoroughly taken into account by the competent authority when setting higher risk weights of LGD values. As a result of these national specificities, the indicative benchmarks which are included in this Regulation should be understood as providing guidance to the competent authorities when setting higher risk weights or higher minimum LGD values and should not automatically trigger the setting of higher risk weights or LGD values for exposures secured by immovable property.

(10) When competent authorities set higher risk weights than those referred to in Article 125(1) or 126(1) of Regulation (EU) No 575/2013 for one or more property segments of such exposures located in the territory of the competent authority and the higher risk weight is below 150%, the competent authority may assign a 150% risk weight as referred to in Article 128 of Regulation (EU) No 575/2013 if the exposure is subject to speculative immovable property financing and when the conditions in that Article are met.

(11) When competent authorities set higher risk weights than those referred to in Article 125(1) or 126(1) of Regulation (EU) No 575/2013 for one or more property segments of such exposures located in the territory of the competent authority and where changes in the intensity of macroprudential or systemic risk in the financial system are identified with the potential to have serious negative consequences to the financial system and the real economy, the measures referred to in Article 458 of Regulation (EU) No 575/2013 may be used when the conditions specified in this Article are met.

(12) When competent authorities set higher minimum values of exposure weighted average LGD for exposures secured by property located in their territory, they shall take into account that institutions use LGD estimates that are appropriate for an economic downturn pursuant to Article 181(1)(b) of Regulation (EU) No 575/2013.

(13) This Regulation is based on the draft regulatory technical standards submitted by the European Banking Authority to the Commission.

(14) The European Banking Authority has conducted open public consultations on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the opinion of the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) 1093/2010[3],

[3] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).

HAS ADOPTED THIS REGULATION:

Article 1
General

1. When competent authorities set higher risk weights than those referred to in Article 125(1) or 126(1) of Regulation (EU) No 575/2013 for one or more property segments of such exposures located in their respective territory, competent authorities shall take into account all of the following conditions:

    (a) the combined result of the assessment of the appropriateness of the risk weights referred to in Article 124(2) of Regulation (EU) No 575/2013 and the methodology set out in Article 2 of this Regulation;

    (b) financial stability considerations, in accordance with the provisions of Article 3 of this Regulation;

    (c) the other conditions referred to in Article 4 of this Regulation.

2. When competent authorities set higher minimum values of exposure weighted average Loss Given Default (LGD) than those referred to in Article 164(4) of Regulation (EU) No 575/2013 for exposures secured by property in their territory, competent authorities shall take into account all of the following conditions:

    (a) the combined result of the assessment of the appropriateness of the minimum LGD values referred to in Article 164(5) of Regulation (EU) No 575/2013 and the methodology set out in Article 5 of this Regulation;

    (b) financial stability considerations, in accordance with the provisions of Article 3 of this Regulation;

    (c) the other conditions referred to in Article 6 of this Regulation.

Question 1: Do you agree with the three main categories of conditions specified for the setting of higher risk weights (paragraph 1) and the setting of higher minimum LGD values (paragraph 2)?

Article 2

Results of the assessment of the appropriateness of the risk weights

1. For the purposes of Article 1(1)(a), competent authorities shall carry out all of the following:

   (a) determine the loss experience relating to one or more property segments of exposures secured by immovable property referred to in point (a) of the first subparagraph of Article 124(2) of Regulation (EU) No 575/2013 based on the data and indicators referred to therein, as a ratio of losses stemming from those exposures to those exposure values. For the purpose of using the data collected under Article 101 of Regulation (EU) No 575/2013, competent authorities shall determine the ratio of the data referred in Article 101(1)(a) or (d) of that Regulation to the data referred to in Article 101(1)(c) or (f) of that Regulation;

   (b) determine the losses which they expect to be realised for the exposures referred to in point (a) ('loss expectation'), in accordance with the process set out in paragraph 2, as a ratio of losses expected to be realised for those exposures to those exposure values;

   (c) consider the indicative benchmarks referred to in paragraph 3, unless other mitigating factors justify deviation from such benchmarks.

2. For the purposes of paragraph 1(b), the loss expectation shall be determined by adjusting the loss experience referred to in paragraph 1(a) to reflect the forward-looking immovable property market developments referred to in point (b) of the first subparagraph of Article 124(2) of Regulation (EU) No 575/2013. Such adjustments shall be based on any of the following:

   (a) the historical evolution in the immovable property market in terms of the immovable property market prices and the volatility in these prices, evidenced by the relevant data indicators;

   (b) the expected evolution in immovable property market prices and the expected volatility in those prices, including an assessment of the uncertainty around these expectations;

   (c) the time horizon over which the forward-looking property market developments are expected to materialise;

(d) the fundamental drivers of demand and supply in the immovable property market, and more in particular, the loan-to-value ratio and the debt service-to-income ratio, evidenced by the relevant data indicators;

(e) the past and present structural and cyclical characteristics of the immovable property market, where structural characteristics may relate to the historical volatility in immovable property prices, the size of the immovable property market, national taxation systems and the national regulatory provisions for buying, holding or letting immovable property;

(f) the overall increase of total risk-weighted exposure amounts for exposures secured by immovable properties across institutions that would result from increasing the risk weights for exposures secured by immovable property market has already been achieved by the smaller fully and completely secured parts of these exposures resulting from reductions to the collateral values of immovable property which the institutions have made in order to reflect forward-looking developments in the immovable property market or to meet the requirements on monitoring of property values and of property valuation as referred to in Article 208(3) of Regulation (EU) No 575/2013.

3. The competent authority may be more conservative in determining the loss expectation referred to in point (b) of paragraph 1 when one or both of the following conditions are met:

(a) the uncertainty around the expectations referred to in point (b) of paragraph 2 is high;

(b) one or several of the data indicators referred to in point (a) of paragraph 1, point (a) or (d) of paragraph 2 are not available over a sufficiently long period.

4. For the purposes of paragraph 1(c), the indicative benchmarks shall be:

(a) a loss expectation below or equal to [0.10-1.5%] is generally appropriate for the 35% risk weight of exposures fully and completely secured by residential property as referred to in Article 125(1) of Regulation (EU) No 575/2013 or one or more property segments of such exposures;

(b) a loss expectation below or equal to [0.15-2%] is generally appropriate for the 50% risk weight of exposures fully and completely secured by commercial immovable property as referred to in Article 126(1) of Regulation (EU) No 575/2013 or one or more property segments of such exposures.

Question 2: Do you agree with the conditions for specification of the loss experience and the loss expectations? Do you agree with the adjustments allowed to be made to the loss experience on the basis of the forward-looking immovable property market developments?

Question 3: Do you agree with the indicative benchmarks for the assessment of the appropriateness of the risk weights and to guide the setting of higher risk weights across immovable property markets in different member states as specified in Article 4(3) and 4(4)? What levels of these indicative benchmarks would be most appropriate and why?

Explanatory box for consultation purposes:

With regard to the indicative benchmarks, this CP consults on the appropriate level of benchmarks within the ranges specified in Article 2(4), 4(3) and 4(4). Including benchmarks contributes to the level playing field, by avoiding for instance that one competent authority sets the risk weight for exposures fully and completely secured by residential property to 50% for a given level of loss expectations, whereas another competent authority would set that risk weight to 150% for the same level of loss expectations.

This CP consults on indicative benchmarks which provide a mapping between the loss expectation determined by the CA and the higher risk weight set by the CA for those corresponding exposures. More specifically, this CP proposes one benchmark to indicate what average level of loss expectation is appropriate for setting the risk weight of exposures fully and completely secured by RRE (CRE) between 35% (50%) and 100%, and a second benchmark to indicate what level of loss expectation is appropriate for setting the risk weight of exposures fully and completely secured by RRE (CRE) between 100% and 150%. Respondents to this CP are asked to provide feedback on what would be the most appropriate level within this range. Regarding the second indicative benchmark (indicated [x%] in Article 4(3)(b) and 4(4)(b)), respondents are asked to provide input on what would be the appropriate level of average loss expectation to indicate that the risk weight on exposures fully and completely secured by RRE or CRE should be set between 100% and 150%.

Each proposed measure by the competent authorities will be assessed by EBA on a case-by-case basis. This assessment will take into account all local market-specific elements, indicators and mitigating factors, such as for instance the number and severity of higher losses. EBA will provide feedback to those competent authorities when they consult EBA on the higher risk weights set (Article 124(2) CRR) or notify EBA on the higher minimum values of LGD (Article 164(5) CRR).

Article 3
Financial stability considerations

1. For the purposes of Article 1(1)(b) and Article 1(2)(b), financial stability considerations shall be deemed to exist where refraining from setting higher risk weights or higher minimum LGD values would have a material impact on the current or future stability of the financial system in one of the following ways:

   (a) one or several global systemically important institutions or other systemically important institutions in the territory of the competent authority as referred to in Article 131 of Directive (EU) No 2013/36/EU risk being impacted by the loss expectation referred to in Article 2(1)(b) or the LGD expectation referred to in Article 5(1)(b) of this Regulation, in such a way that could result in a significant decline in the resilience of the financial system or a material disruption in the flow of lending to the economy when losses materialize;

   (b) several institutions with exposures in the territory of the competent authority risk being impacted by the loss expectation referred to in Article 2(1)(b) or the LGD expectation referred to in Article 5(1)(b) of this Regulation, in such a way that could result to spill-over effects to other exposures which may lead to a significant decline in the resilience of the financial system or a material disruption in the flow of lending to the economy;

   (c) forward-looking immovable property market developments that are determined by structural characteristics as referred to in points (e) of Article 2(2) or Article 5(2) and this may lead to a significant decline in the resilience of the financial system or a material disruption in the flow of lending to the economy when this risk materializes.

2. For the purpose of the assessment of financial stability considerations referred to in paragraph 1, competent authorities shall take the potential pro-cyclical effects of one of the scenarios specified in points (a) to (c) of that paragraph into account.

Question 4: Do you agree with the specification of the term of “financial stability considerations”?

Article 4
Other conditions when setting higher risk weights

1. For the purposes of Article 1(1)(c), competent authorities shall consider the indicative benchmarks specified in paragraphs 3 and 4 and determine all of the following:

(a) an explanation as to why increasing the risk weights is deemed to mitigate the financial stability considerations referred to in Article 3 of this Regulation;

(b) an explanation as to why the risk weights are increased in a way that ensures correspondence between the higher risk weight and the loss expectation related to one or more property segments and as referred to in Article 2(1) of this Regulation;

(c) an assessment of the potential pro-cyclical effects of setting higher risk weights in the current stage of the economic cycle on the financial stability considerations referred to in point (a).

2. When a competent authority sets a higher risk weight to one or more property segments of such exposures located in its respective territory, the competent authority shall in addition to the provisions in paragraph 1, verify that all of the following conditions for the specification of the property segment are met:

   (a) a clear definition of the property segment, which can easily be understood by institutions in other EU member states and which ensures a consistent application of the definition over time, is provided;

   (b) the property segment is identified as a homogenous group of exposures of a significant size based on the type of real estate exposure or based on the geographical location.

3. When competent authorities set higher risk weights than those referred to in Article 125(1) of Regulation (EU) No 575/2013 for one or more property segments of such exposures located in the territory of the competent authority within the ranges specified in the third and fourth subparagraph of Article 124(2) of that Regulation, they shall take into account all of the following:

   (a) a loss expectation above [0.10-1.5%] but lower than [x%] is generally appropriate for increasing the 35% risk weight of exposures fully and completely secured by residential property as referred to in Article 125(1) of Regulation (EU) No 575/2013 or one or more property segments of such exposures up to but below 100%;

   (b) a loss expectation equal to or above [x%] is generally appropriate for increasing the 35% risk weight of exposures fully and completely secured by residential property as referred to in Article 125(1) of Regulation (EU) No 575/2013 or one or more property segments of such exposures to a risk weight ranging from 100% to 150%.

4. When competent authorities set higher risk weights than those referred to in Article 126(1) of Regulation (EU) No 575/2013 for one or more property segments of such exposures located in the territory of the competent authority within the ranges specified in the third and fourth subparagraph of Article 124(2) of that Regulation, they shall take into account all of the following:

   (a) a loss expectation above [0.15-2%] but lower than [x%] is generally appropriate for increasing the 50% risk weight of exposures fully and completely secured by commercial immovable property as referred to in Article 126(1) of Regulation (EU) No 575/2013 or one or more property segments of such exposures up to but below 100%;

   (b) a loss expectation equal to or above [x%] is generally appropriate for increasing the 50% risk weight of exposures fully and completely secured by commercial immovable property as referred to in Article 126(1) of Regulation (EU) No 575/2013 or one or more property segments of such exposures to a risk weight ranging from 100% to 150%.

Question 5: Do you agree with the other conditions for the setting of higher risk weights? (Please provide your feedback related to the indicative benchmarks (in Article 3(3) and 3(4)) in your response to Question 3 above.)

Article 5

Results of the assessment of the appropriateness of the minimum LGD values

1. For the purposes of Article 1(2)(a), competent authorities shall carry out all of the following:

   (a) determine the exposure weighted average LGD for retail exposures secured by immovable property in their territory, as referred to in Article 164(4) of that Regulation and calculated according to the requirements for own-LGD estimates in Article 181 of Regulation (EU) No 575/2013, based on the data and indicators referred to therein and in particular the exposure weighted average LGD for these exposures reported by institutions according to the Commission Implementing Regulation (EU) No 680/2014;

   (b) determine the exposure weighted average LGD which they expect to be realised for the exposures referred to in point (a) ('LGD expectation'), in accordance with the process set out in paragraph 2.

2. For the purposes of paragraph 1(b), the LGD expectation shall be determined by adjusting the exposure weighted average LGD referred to in paragraph 1(a) to reflect the forward-looking immovable property market developments referred to in Article 164(5) of Regulation (EU) No 575/2013. Such adjustments shall be based on all of the following:

   (a) the historical evolution in the immovable property market in terms of the immovable property market prices and the volatility in these prices, evidenced by the relevant data indicators;

   (b) the expected evolution in immovable property market prices and the expected volatility in those prices, including an assessment of the uncertainty around these expectations;

   (c) the time horizon over which the forward-looking property market developments are expected to materialise;

   (d) the fundamental drivers of demand and supply in the immovable property market, and more in particular, the loan-to-value ratio and the debt service-to-income ratio, evidenced by the relevant data indicators;

   (e) the past and present structural and cyclical characteristics of the immovable property market, where structural characteristics may relate to the historical volatility in immovable property prices, the size of the immovable property market, national taxation systems and the national regulatory provisions for buying, holding or letting immovable property;

   (f) the increase in capital requirements for exposures secured by immovable properties across institutions that would result from increasing the minimum LGD value for exposures secured by immovable property as referred to in in Article 164(4) of Regulation (EU) No 575/2013 has already been achieved by the reductions to the collateral values of immovable property which the institutions have made in order to reflect forward-looking developments in the immovable property market or to meet the requirements on monitoring of property values and of property valuation as referred to in Article 208(3) of Regulation (EU) No 575/2013.

5. The competent authority may be more conservative in determining the LGD expectation referred to in point (b) of paragraph 1 when one or both of the following conditions are met:

(c) the uncertainty around the expectations referred to in point (b) of paragraph 2 is high;

(d) one or several of the data indicators referred to in point (a) of paragraph 1, point (a) or (d) of paragraph 2 are not available over a sufficiently long period.

Question 6: Do you agree with the conditions for specification of the exposure weighted average LGD and the LGD expectation? Do you agree with the adjustments allowed to be made to the average exposure weighted LGD on the basis of the forward-looking immovable property market developments? Do you agree that it is not appropriate to set indicative benchmarks for the setting of higher minimum LGD values because of the specificities of national immovable property markets and because of the relationship of the LGD parameter with the other internal model parameters?

Article 6

Other conditions when setting higher minimum LGD values

For the purposes of Article 1(2)(c), competent authorities shall determine all of the following:

(a) an explanation as to why increasing the minimum LGD value is deemed to mitigate the financial stability considerations referred to in Article 3 of this Regulation;

(b) an explanation as to why the minimum LGD values are increased in a way that ensures correspondence between the higher minimum LGD value and the LGD expectation related to that portfolio as referred to in Article 5(1)(b) of this Regulation;

(c) an assessment of the potential pro-cyclical effects of setting higher minimum LGD values in the current stage of the economic cycle on the financial stability considerations referred to in point (a).

Explanatory box for consultation purposes:

This CP does not include indicative benchmarks for the setting of higher exposure weighted minimum LGD values because of two main reasons. First, the downturn LGD is an internal model parameter which may be estimated in a different way across bank's portfolios. This is due to the fact that LGD estimates should be appropriate for an economic downturn more conservative than the long-run average. In particular for real estate markets where cyclical fluctuations are very diverse and country or even market-specific and it is therefore difficult to specify indicative numbers for the loss rates, observed LGDs or LGD expectation. Secondly, the LGD is an IRB model parameter which interacts with other internal model parameters, and there is no direct link between local markets loss experience and institution's own-LGD estimates, as this depends on institution specific portfolios. This approach is different from the conditions proposed in the CP for setting higher risk weights, because there is a direct link between loss rates and risk weights in the Standardised Approach where the underlying assumption is made that the local market conditions and the bank exposures are aligned.

Question 7: Do you agree with the other conditions for the setting of higher minimum LGD values?

Article 7
Final provision

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Commission

The President

On behalf of the President
[Position]

5. Accompanying documents

5.1 Draft Cost- Benefit Analysis / Impact Assessment

Introduction

Article 124(4)(b) CRR mandates the EBA to 'specify the conditions that competent authorities shall take into account when determining higher risk-weights, in particular the term of "financial stability considerations"'. Furthermore, Article 164(6) CRR similarly mandates the EBA to specify the conditions that competent authorities shall take into account when determining higher minimum LGD values'.

As per Article 10(1) of the EBA regulation (Regulation (EU) No 1093/2010 of the European Parliament and of the Council), any draft RTS developed by the EBA shall be accompanied by a cost and benefit analysis. Such annex shall provide the reader with an overview of the findings as regards the problem identification, the options identified to remove the problem and their potential impacts.

This section presents the impact assessment of the policy options considered in these RTS. Due to lack of available data on these policy options considered, the analysis of these options is mainly qualitative.

Background

The CRR mandates the EBA to develop the draft RTS to specify the conditions that competent authorities shall take into account when determining higher risk weights or higher minimum LGD values. Competent authorities may set higher risk weights, stricter criteria or minimum LGD values for exposures secured by immovable property on the basis of the loss experience and taking into account forward-looking immovable property developments and financial stability considerations. These draft RTS should provide harmonization in the setting of higher risk weights and minimum LGD values across member states.

Technical options considered

This section identifies the pros and cons of the policy options. When relevant the costs and benefits of the policy options are also assessed. However, it is worth noticing that it is difficult to anticipate whether the implementation of the draft RTS is expected to generate excessive additional costs, as this ultimately depends on the feedback from the consultation, as well as the exact transitional provisions, how immovable property markets will further evolve and whether competent authorities will make use of the option to set higher risk weights or LGDs.

The conditions specified in these proposed draft RTS are deemed to be reasonable, clear and simple which should ensure that the implementation by public authorities can be done as smoothly as possible. Furthermore, these proposed draft RTS aim to provide guidance to competent authorities on which conditions they should take into account in their assessment of the appropriateness of the risk weights and minimum LGD values.

Specification of data indicators for forward-looking immovable property market developments and financial stability considerations

This CP specifies in Article 2 that certain data are specified, i.e. loss experience, immovable property market prices, the loan-to-value ratio and the debt-service-to- income ratio. For the specification of financial stability considerations in Article 3, the CP does not include data indicators which should be considered.

As an alternative option, it has been considered to include a much wider set of data indicators, for instance the list of indicators below. However, such broad list of variables would not help in pointing competent authorities to the essential variables, and therefore it has been decided to specify a minimum list of variables for the analysis of forward-looking immovable property market developments. For the financial stability considerations, it has been chosen to specify no variables, because it not possible to anticipate the exact nature of financial stability considerations given by the set of scenarios in Article 3.

Macroeconomic data

- interest rates, unemployment rates, GDP growth, business climate indices, default rate, non-performing-loan ratio

Macroeconomic data linked to lending

- credit-to-GDP ratio
- RRE/CRE lending volumes (flow) by banks, insurers, pension funds and other sources
- RRE/CRE lending volumes (stock)
  - as a proportion of total lending (by lender type or aggregate)
  - as compared to historical levels (by lender type or aggregate)
  - relative to GDP

Data indicators for lending standards

- debt-to-income ratio and debt service-to-income ratio (on average, and the distribution of lending volumes by these ratios)
- loan-to-value ratio and loan-to-income ratio (on average, and the distribution of lending volumes by these ratios)
- indicators for banks' credit standards at origination

Property market data

- RRE/CRE property prices
- average mortgage maturity
- prime and secondary yield
- spread between prime and secondary yield
- prime and secondary void rates
- prime and secondary market rent
- current and potential supply of developed properties
- capital flows into real estate market (institutional, domestic compared to international)

Debt market data

- total loans outstanding compared to the size of the total RRE/CRE market
- volume of loan vintages/expiries
- RRE/CRE loan volume split by sub-sector (retail, office, industrial, …) or RRE/CRE loan volume split between primary and secondary segment
- indicators for loan concentration among lenders
- prevailing debt rates/margins compared to long-run averages
- cost of debt compared to property yields

Other indicators

- the extent of financial innovation
- market share of different sources of equity capital entering the RRE/CRE sector and the proportion of RRE/CRE debt going to different types of borrowers

Calibration of indicative benchmarks for setting higher risk weights

With regard to the indicative benchmarks, this CP consults on the appropriate level of these benchmarks within the ranges specified in Article 2(4), 4(3) and 4(4). Including benchmarks contributes to the level playing field, by avoiding for instance that one competent authority sets the risk weight for exposures fully and completely secured by residential property to 50% for a given level of loss expectations, whereas another competent authority would set that risk weight to 150% for the same level of loss expectations.

Given that these RTS are setting out conditions for a level one legislation, consistency with level one (CRR) is a necessary prerequisite. As such, it is essential to identify up to which level of losses the risk weights of 35% and 50% for exposures fully and completely secured by RRE and CRE are deemed appropriate. The identification of this level of losses would then give an indication from which level of losses onwards higher risk weights may be considered to be set. For the identification of this implied level of losses, two possible arguments may apply, each of which leads to a different level of losses.

According to the first argument, this implied level of losses can be derived from the level of the overall capital ratio (8%) and the risk weights of 35% and 50% for residential and commercial immovable property. The 8% capital ratio implies that a risk weight of 1250% should cover a loss up to 100% of the exposure value. Consequently, the risk weights of 35% and 50% serve for covering maximum losses up to 2.8% or 4% respectively. This follows from 35%*8% = 2.8% and 50%*8% = 4%. Assuming a normal distribution of losses with a standard deviation of 2, the initial risk weights of 35% and 50% can be understood as in general sufficient for an average loss (or loss expectation) of 1.4% (= 2.8%/2)or 2% (= 4%/2), respectively. Similarly, a risk weight up to 100% is generally appropriate for these exposures for an average loss (expectation) up to 4% (100%*1.4%/35% = 4% and 100%*2%/50% = 4%).

According to the second argument, this implied level of losses referred to above can be derived from the 0.3% level of losses mentioned in paragraph 3(a) in Articles 125 and 126 CRR. Paragraph 2 of Article 125 and 126 CRR specify the criteria whereby an exposure should be considered as fully and completely secured by mortgages on residential respectively commercial immovable property. In particular, paragraph 2(b) in Articles 125 and 126 specifies that the risk of the borrower shall not materially depend upon the performance of the underlying property or project, but on the underlying capacity of the borrower to repay the debt from other sources. Competent Authorities may however derogate from paragraph 2(b) in Articles 125 and 126 CRR, for properties which are situated within the territory of a Member State if, among other conditions, losses[4] do not exceed 0.3% of the outstanding loans collateralised by residential or commercial immovable property in any given year. If one assumes that the 0.3% is a benchmark for increasing risk weights above 100%[5], one can calibrate a benchmark for increasing risk weights above 35%/50% by using a suitable functional form. Assuming a linear functional form, the indicative benchmark for setting a risk weight above 35% is therefore 35%*0.3% (= 0.105 %) whereas the indicative benchmark for setting a risk weight above 50% is 50%*0.3% (= 0.15 %).

Given that both arguments lead to different levels of the indicative benchmarks, this CP consults on a range of levels for these indicative benchmarks in Article 2(4), 4(3) and 4(4). Stakeholders are however asked to provide feedback on the most appropriate level of these benchmarks.

It should however be noticed that, in line with the EBA mandate, this CP for the draft RTS sets out the conditions to be taken into account by the competent authorities, and it should therefore be underlined that these are indicative benchmarks.

Indicative benchmarks for the setting higher LGD floors

The CP does not include indicative benchmarks for the setting of higher LGD floors in Article 6. One alternative option has been to have such indicative benchmarks, but two main reasons have been identified for not including such benchmarks. First, the downturn LGD is an internal model parameter which may be estimated in a different way across jurisdictions and bank's portfolios, at least prior to EBA issuing guidance on this aspect. Second, the LGD is only one of several internal model parameters, and there is no direct link between loss experience and institution's own-LGD estimates.

As regards the specification of the own-LGD estimates, Article 181 CRR sets out the requirements. One of the requirements is that the LGD estimates should be appropriate for an economic downturn if those are more conservative than the long-run average. In particular for real estate markets where cyclical fluctuations are very diverse and country or even market-specific and it is therefore difficult to specify indicative numbers for the loss rates, observed LGDs or LGD expectation.

As regards the interaction between the LGD and other internal model parameters and the absence of a direct link between loss experience and institution's own-LGD estimates, it should be mentioned that the capital requirements in internal models are ultimately determined by the

[4] Losses measured according to Article 101(1)(a) CRR (residential immovable property) or Article 101(1)(d) CRR (commercial immovable property).

[5] This is the applicable risk weight for exposures fully secured by immovable property.

interplay of the individual parameters and are specified by the supervisory formula in Article 153 CRR. As such, the LGD is only one parameter, and its effect on capital requirements may be offset by other parameters, such as for instance PD. In the Standardized Approach, the applicable risk weight should be aligned with the level or risk, proxied by the loss rate, but in the Internal Model Based approach, there is no direct link between the level of losses and the LGD parameter.

Financial stability considerations

The CP specifies financial stability considerations as a situation where refraining from setting higher risk weights or higher minimum LGD values would have a material impact on the current or future stability of the financial system in one out of three specified scenarios, related to the loss expectation or structural risks of the immovable property market.

Two alternative definitions have been considered. First, the definition of financial stability as in the Communication of the European Commission of 30/07/2013 regarding the criteria for the compatibility of state aid with the TFEU[6]. This communication is issued by the Commission in order to provide guidance on the criteria for the compatibility of state aid with the TFEU. State Aid is considered to be still in line with the TFEU in cases of financial stability concerns. This communication contains a definition of financial stability: 'Financial stability implies the need to prevent major negative spill-over effects for the rest of the banking system which could flow from the failure of a credit institution as well as the need to ensure that the banking system as a whole continues to provide adequate lending to the real economy.'

Secondly, the ECB Financial Stability Review of November 2013[7] contains another definition of financial stability: 'Financial stability can be defined as a condition in which the financial system – comprising of financial intermediaries, markets and market infrastructures – is capable of withstanding shocks, thereby reducing the likelihood of disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities'.

It was however considered that neither of these two definitions put sufficient emphasis on financial stability considerations stemming from the immovable property market. Furthermore, it is necessary for the purpose of these draft RTS to link the financial stability considerations to the loss expectation.

Data requirements and availability

In the specification of data indicators for the forward-looking immovable property market developments, it has been considered whether it should be required to have quantitative data as a condition for adjusting the loss experience or observed LGD. Data indicators are unfortunately

[6] http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52013XC0730%2801%29

[7] http://www.ecb.europa.eu/pub/fsr/html/index.en.html

not always available in all national immovable property markets, and therefore it is questionable whether strict data requirements would prevent competent authorities from setting higher risk weights or minimum LGD values. In the light of financial stability considerations that have been associated with previous real estate crisis in several EU member states, the CP requires that a minimum set of indicators should be evidenced, i.e. loss experience, immovable property market prices, the loan-to-value ratio and the debt service to income ratio. However, this CP has also taken a prudent approach and specifies that the competent authority may be more conservative in its assessment of the loss or LGD expectation when there is more uncertainty about the expected evolution in immovable property market prices or the expected volatility in those prices or when certain data indicators are not available over a sufficiently long period.

Question 8: Do you have any suggestions on the Impact Assessment?

5.2 Overview of questions for Consultation

Question 1: Do you agree with the three main categories of conditions specified for the setting of higher risk weights (paragraph 1) and the setting of higher minimum LGD values (paragraph 2)?

Question 2: Do you agree with the conditions for specification of the loss experience and the loss expectations? Do you agree with the adjustments allowed to be made to the loss experience on the basis of the forward-looking immovable property market developments?

Question 3: Do you agree with the indicative benchmarks for the assessment of the appropriateness of the risk weights and to guide the setting of higher risk weights across immovable property markets in different member states as specified in Article 4(3) and 4(4)? What levels of these indicative benchmarks would be most appropriate and why?

Question 4: Do you agree with the specification of the term of "financial stability considerations"?

Question 5: Do you agree with the other conditions for the setting of higher risk weights? (Please provide your feedback related to the indicative benchmarks (in Article 3(3) and 3(4)) in your response to Question 3 above.)

Question 6: Do you agree with the conditions for specification of the exposure weighted average LGD and the LGD expectation? Do you agree with the adjustments allowed to be made to the average exposure weighted LGD on the basis of the forward-looking immovable property market developments? Do you agree that it is not appropriate to set indicative benchmarks for the setting of higher minimum LGD values because of the specificities of national immovable property markets and because of the relationship of the LGD parameter with the other internal model parameters?

Question 7: Do you agree with the other conditions for the setting of higher minimum LGD values?

Question 8: Do you have any suggestions on the Impact Assessment?