EBA/CP/2021/18

29 April 2021

Consultation Paper

Draft Regulatory Technical Standards

specifying the types of factors to be considered for the assessment of appropriateness of risk weights under Article 124 (4) of Regulation 575/2013 and the conditions to be taken into account for the assessment of appropriateness of minimum LGD values under Article 164 (8) of Regulation 575/2013

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 29 July 2021. 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 (EU) 1725/2018 of the European Parliament and of the Council of 23 October 2018. Further information on data protection can be found under the Legal notice section of the EBA website.

2. Executive Summary

Under Articles 124 (4) and 164 (8) of Regulation (EU) No 575/2013 (CRR), the EBA is mandated to develop, in close cooperation with the ESRB, draft regulatory technical standards (RTS) to specify:

i) The rigorous criteria for the assessment of the mortgage lending value (MLV) referred to in paragraph 1 of Article 124[1] CRR;

ii) The types of factors to be considered for the assessment of the appropriateness of the risk weights referred to in the first subparagraph of paragraph 2 of Article 124 CRR; and

iii) The conditions that the authority designated by the Member State shall take into account when assessing the appropriateness of minimum loss given default (LGD) values as part of the assessment referred to in paragraph 6 of Article 164 CRR.

Given the rather similar nature of the mandates in both abovementioned Articles 124 (4) and 164 (8) CRR, these elements are specified jointly in this Consultation Paper (CP) for these draft RTS. Namely, the mandates deal with the assessments of the appropriateness of risk weights for institutions applying the Standardised Approach (SA) or minimum LGD values for institutions applying the Internal Ratings-Based (IRB) Approach. In addition, the CP also takes into account other major changes introduced to Article 124 and Article 164 through Regulation (EU) 2019/876 amending Regulation (EU) No 575/2013. Most importantly, the relevant authority as designated by the Member State may set higher risk weights or impose stricter criteria on risk weights, or increase the minimum LGD values when the following two conditions are met:

1. based on the periodical assessments of risk weights or minimum LGD values, the relevant authority concludes that the risk weights set out in Article 125 (2) or 126 (2) CRR do not adequately reflect the actual risks related to the exposures secured by mortgages on residential property or commercial immovable property, or that the minimum LGD values referred to in Article 164 (4) CRR are not adequate;

2. the relevant authority considers that the identified inadequacy of these risk weights or minimum LGD values could adversely affect the current or future financial stability in its Member State.

The scope of the mandate given to the EBA pertains to the first condition. For institutions applying the SA, these draft RTS specify the types of factors to be considered during the appropriateness assessment of risk weights on the basis of the loss experience and forward-looking immovable property market developments. In particular, the draft RTS delineate the types of factors to be taken into account in the determination of the loss expectation.

For institutions applying the IRB Approach to retail exposures secured by residential or commercial immovable property, these draft RTS provide three conditions to be considered when

[1] This element lays down the mandate to develop a draft RTS specifying the rigorous criteria for the assessment of MLV. In 2015, the EBA provided an opinion advising the Commission to limit the scope of application of this RTS on MLV to the SA, Credit Risk Mitigation framework and Large Exposures. The preparation of this draft RTS awaits the forthcoming revision of the CRR.

assessing the appropriateness of minimum LGD values. In particular, the draft RTS emphasise the systemic risk approach of such an appropriateness assessment. This is due to (i.) the existing approval, validation and close monitoring of rating systems under the IRB Approach by competent authorities and (ii.) the requirements for institutions to use LGD estimates that are appropriate for an economic downturn if those are more conservative than the long-run average LGD, which is further specified in regulatory technical standards and EBA Guidelines.

For both assessments, proper coordination and cooperation between the competent and the designated authority are key to strengthen the identification of risks and to avoid overlaps, double counting of risk and duplicative actions by authorities.

Next steps

The finalisation of the draft RTS and communication to the European Commission is planned by 31 October 2021.

3. Background and rationale

1. Article 124 (2) and Article 164 (6) of Regulation (EU) No 575/2013 (hereinafter CRR1) as applicable before the date of entry into force of Regulation (EU) 2019/876 (hereinafter CRR2) required competent authorities to assess periodically, and at least annually, whether risk weights under Articles 125 and 126 of CRR1 or the minimum average loss given default (LGD) values under Article 164 of CRR1 reflected the actual risk of exposures secured by mortgages on immovable property or were appropriate for retail exposures secured by immovable property, respectively. These articles share common characteristics because both deal with adjustments to input parameters for the determination of own funds requirements for exposures secured by immovable property, although they cover two different approaches when calculating own funds requirements: SA and IRB Approach.

2. However, CRR2 introduced a series of changes (including new features) to these two articles. First, whereas originally in CRR1 the competent authority had the responsibility for the assessments and the decisions on setting higher risk weights or imposing stricter criteria than those set out in Article 125 (2) and 126 (2) or on setting other minimum average exposure-weighted LGD values (hereafter referred as "minimum LGD values"), Member States shall designate an authority responsible for the application of these provisions. Pursuant to CRR2, that authority shall be the competent authority or the designated authority (hereinafter the "relevant authority").

3. Second, regardless of the choice made by the Member State (see paragraph 2), both authorities shall cooperate closely and share all information that may be necessary for the adequate performance of the duties, when these provisions are used in accordance with Article 124 (1a) and Article 164 (5) of the CRR2.

4. Third, and most important, the macroprudential purpose of increasing risk weights or minimum LGD values has been strengthened mainly by requiring the fulfilment of two conditions before the relevant authority may set higher risk weights or higher minimum LGD values:

    1) Based on the periodical assessments of risk weights or minimum LGD values[2], the relevant authority concludes that the risk weights and/or the current minimum LGD values do, in the case of risk weights, not adequately reflect the actual risks related to the exposures secured by mortgages on residential property or commercial immovable property, or are, in the case of minimum LGD values, not adequate (in both cases, if deemed relevant, also by decomposition of immovable property segments and/or territory).

[2] Similar to CRR1, the relevant authority is required to assess whether the risk weights for exposures fully and completely secured by immovable property set out under the SA (i.e. 35% for exposures secured by residential property and 50% for exposures secured by commercial immovable property) are appropriate based on the loss experience of exposures secured by immovable property and the forward-looking market developments in the real estate markets. A similar assessment is also required for the appropriateness of the current minimum average LGD values for retail exposures secured by immovable property (i.e. 10% floor for retail exposures secured by residential property and 15% floor for retail exposures secured by commercial immovable property).

2) The relevant authority considers that the identified inadequacy of the current risk weights and/or minimum LGD values could adversely affect the current or future financial stability of the Member State.

5. Fourth, CRR2 splits the mandate, originally given to the EBA in CRR1, in two parts and shares the responsibility between the EBA and the ESRB. On the one hand, the EBA is entrusted in close cooperation with the ESRB, to develop draft RTS specifying the following:

   a) The rigorous criteria for the assessment of the mortgage lending value (MLV);

   b) The types of factors to be considered for the assessment of the appropriateness of the risk weights under the SA, and

   c) The conditions to be considered for the assessment of the appropriateness of minimum LGD values under the IRB Approach.

6. The first element above lays down the mandate to develop a draft RTS specifying the rigorous criteria for the assessment of MLV. Nevertheless, the EBA provided in 2015 an opinion advising the Commission to limit the scope of application of these RTS (concerning MLV) to the SA, Credit Risk Mitigation framework and Large Exposures.[3] Therefore, the preparation of these draft RTS (concerning MLV) awaits the forthcoming revision of Regulation (EU) No 575/2013.

7. On the other hand, the ESRB, in close cooperation with the EBA, may issue a recommendation giving guidance to the relevant authorities on the factors which could adversely affect the current or future financial stability of the activating Member State, and on indicative benchmarks that the relevant authority has to take into account when determining higher risk weights or minimum LGD values.

8. Fifth, CRR2 allows for setting higher risk weights and minimum LGD values for selected exposures located in one or more parts of the territory of the Member State as well as at the level of one or more immovable property segments.

9. Overall, compared to the previous mandates given in CRR1, the scope of the current mandates given to the EBA in CRR2 is narrowed down to specify the types of factors to be considered for the appropriateness assessment of risk weights or the conditions to be taken into account when assessing the appropriateness of minimum LGD values. Therefore, the draft RTS specified in this document determine solely the types of factors or the conditions that relevant authorities shall consider in their assessments in light of the developments in their respective national real estate markets. For these reasons, these draft RTS do not include considerations on financial stability nor details on indicative benchmarks for the calibration of any increases in risk weights or minimum LGD values.

10. The key elements of these draft RTS for the assessment of the appropriateness of risk weights under the SA are the loss experience and the loss expectation related to exposures secured by immovable property within the respective Member State. The loss expectation, as the forward-looking

[3] https://www.eba.europa.eu/sites/default/documents/files/documents/10180/983359/37076e22-e8b2-42e4-979d-0edcfce810c1/EBA-Op-2015-17%20Opinion%20on%20mortgage%20lending%20value.pdf?retry=1

perspective of the assessment, is defined as the relevant authority's best estimate of losses to be realised during a forward-looking horizon of at least one year and up to three years. This loss expectation should be determined by adjusting the loss experience on the basis of types of factors including the immovable property market developments (i.e. the fundamental drivers of demand and supply, the structural and cyclical characteristics) and the future macroeconomic conditions (i.e. forecasts of key macroeconomic variables).

11. The length of the forward-looking horizon of at least one year and up to three years is subject to the decision of the relevant authority. This decision should take into consideration the characteristics and actual developments of the immovable property market, the risk of underestimating the vulnerabilities stemming from that market, the position in its economic and financial cycles, and the fact that the appropriateness assessment shall be conducted at least once a year. Although a longer horizon could allow for an early-on built-up of resilience in times when the systemic risks are increasing, a horizon above 3 years may increase the degree of inaccuracy of the loss expectation.

12. Although risk weights under the SA and minimum LGD values under the IRB Approach share common characteristics as both are elements needed in the calculation of own funds requirements for exposures (SA) or for retail exposures (IRB Approach) secured by immovable property, the approach on how to assess their appropriateness differs. Besides, from a microprudential perspective, IRB Approaches with own estimates of LGD are approved and closely monitored by supervisors and regularly validated by institutions. Furthermore, rating systems are subject to a degree of conservatism pursuant to the requirements for the IRB Approach under Regulation (EU) No 575/2013.

13. Nevertheless, IRB Approaches may not capture all risks from a macroprudential perspective. An assessment of appropriateness of minimum LGD values in these RTS should therefore consider whether the minimum LGD values cover for the sources of systemic risks beyond the economic downturn considerations (as further specified in regulatory technical standards and EBA guidelines) and idiosyncratic risks. For this purpose, the relevant authority is asked to perform a systemic risk assessment taking into account macroeconomic imbalances impacting LGD values beyond the economic cycle based on the following conditions: demand and supply conditions of real estate markets and dynamics in real estate prices, conditions that impact on drivers of LGD values and other conditions that indirectly impact on the value of collateral taken into account in LGD estimation.

14. In general, the assessment of appropriateness of minimum LGD values should consider the regulatory guidance on LGD estimation provided by the EBA Guidelines on PD estimation, LGD estimation and the treatment of defaulted assets, the EBA Guidelines for the estimation of LGD appropriate for an economic downturn, the final draft RTS on the specification of the nature, severity and duration of an economic downturn , and the EBA Guidelines on credit risk mitigation for institutions applying the IRB Approach with own estimates of LGDs.

15. An important provision mentioned in CRR2 is the cooperation and coordination between the competent authority and the designated authority. Such requirement ensures a complete assessment of appropriateness of risk weights or minimum LGD values, including the proper identification of risks, the avoidance of overlaps, double counting of risks as well as duplicative or

inconsistent actions. Besides, cooperation and coordination ensure that the interaction with other measures, in particular those taken under Article 458 of the CRR2 and Article 133 of Directive 2013/36/EU, is duly taken into account.

16. These draft RTS are meant to support the periodical assessments of appropriateness of risk weights or minimum LGD values. For this purpose, the types of factors or the conditions that relevant authorities shall consider during such assessments must rely on the latest data available to them. Furthermore, these draft RTS together with an ESRB recommendation (see paragraph 7) are meant to provide a framework for the relevant authority when setting higher risk weights than those set out in Article 125 (1) or 126 (1) of CRR2 and when setting higher minimum LGD values than those referred to in Article 164 (4) of the same Regulation. When considering any changes to risk weights or minimum LGD values, the relevant authority should also be aware of the direct linkages to other parts of the regulation, including the impact of such changes on the calculation of large exposure values, liquidity and capital ratios, reporting requirements and other macroprudential measures.

17. In addition to the adequate consideration of the loss experience and the differences between assessing risk weights under the SA or minimum LGD values under the IRB Approach, the draft RTS also pay attention to other key elements for the appropriateness assessments, which include:

a) The existence of national specificities related to the real estate market and its financing, such as public and private guarantee schemes, tax deductibility, recourse regimes or social safety nets;

b) The assessment at the level of parts of the territory or at the level of specific property segments, if deemed relevant (see paragraph 8); and

c) The data problems concerning relevant indicators, such as availability, quality, granularity or harmonisation.

4. Draft regulatory technical standards

In between the text of the draft RTS/ITS/Guidelines/advice that follows, further explanations on specific aspects of the proposed text are occasionally provided, which either offer examples or provide the rationale behind a provision, or set out specific questions for the consultation process. Where this is the case, this explanatory text appears in a framed text box.

COMMISSION DELEGATED REGULATION (EU) …/..

of XXX

supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards specifying the types of factors to be considered for the assessment of the appropriateness of risk weights and the conditions to be taken into account for the assessment of appropriateness of 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[4], and in particular the third subparagraph of Article 124(4) and the third subparagraph of Article 164(8) thereof,

Whereas:

(1) To ensure coherence between the assessments of the appropriateness of input parameters for the determination of own funds requirements for exposure types secured by immovable property set out in Article 124 (2) of Regulation (EU) No 575/2013 and in Article 164 (6) of that Regulation, it is appropriate to include both sets of the relevant regulatory technical standards required by Article 124 (4) and by Article 164 (8) of Regulation (EU) No 575/2013 respectively in a single Regulation. Considering that the assessments of appropriateness of risk weights or minimum LGD values are distinct from the specification of the rigorous criteria for the assessment of the mortgage lending value, the scope of this Regulation is limited to the types of factors or conditions required for these assessments.

(2) To ensure a harmonised approach in the periodical assessments referred to in Article 124 (2) and Article 164 (6) of Regulation (EU) No 575/2013 performed by the authorities set out in Article 124 (1a) and Article 164 (5) of that Regulation, this Regulation specifies the types of factors to be considered in the assessment of the appropriateness of the risk weights and the conditions to be considered for the assessment of the appropriateness of minimum LGD values, respectively.

(3) To ensure proportionality, there is a need to account for the heterogeneity of the immovable property markets across Member States while at the same time setting out a sufficiently harmonised framework for the assessments of the appropriateness of the risk weights and the minimum LGD values in accordance with Article 124 (2) and Article 164 (6) of Regulation (EU) No 575/2013. To that end, the Regulation stops short from imposing a one-size-fits-all approach and provides instead the authorities set out in Article 124 (1a) and Article 164 (5) of Regulation (EU) No

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

575/2013 with all the necessary elements as to the types of factors or the conditions for the purposes of their assessments.

(4) Against this background, this Regulation strikes a balance between achieving harmonisation and preserving the flexibility necessary for the performance of the assessments referred to in Article 124 (2) and in Article 164 (6) of Regulation (EU) No 575/2013, having also regard to the fact that the ultimate decision as to the appropriateness of the risk weights and of the appropriateness of minimum LGD values lies within the competence of the authorities set out in Article 124 (1a) and Article 164 (5) of that Regulation

(5) To further specify the loss expectation to be considered for the purposes of determining the appropriateness of risk weights, this Regulation lays down the types of factors to be taken into account, in particular, the historical evolution and cyclical characteristics of the immovable property market as reflected in immovable property market transactions and prices and in their volatility, the past and present structural characteristics of the immovable property market, the fundamental drivers of demand and supply in the immovable property market, the riskiness of the exposures secured by immovable property, the expected evolution in immovable property market prices and the expected volatility in those prices, the expected evolution in meaningful macroeconomic key variables that could affect the solvency of borrowers, the time horizon over which the forward-looking property market developments are expected to materialise, the national specificities related to the real estate market and its financing, and any other data indicators and sources which provide insight into the forward-looking property market developments.

(6) Where specifying the conditions for assessing the appropriateness of minimum LGD values, this Regulation should focus on aspects beyond economic downturn and idiosyncratic risks. To target the sources of systemic risk, elements such as the demand and supply conditions of real estate markets, the dynamics in real estate prices, conditions that impact on drivers of LGD values, and other conditions that indirectly impact on the value of collateral taken into account in LGD estimates, should be taken into account.

(7) Where specifying the conditions for determining the appropriateness of minimum LGD values, this Regulation sets out a number of considerations to be taken into account, among them whether macroeconomic imbalances are related to an economic downturn, whether other macroprudential measures in force already address the identified systemic risks, the degree of uncertainty around the evolution of immovable property markets, national specificities related to the real estate market and its financing, and relevant benchmarking comparisons of LGD estimates across institutions or Member States.

(8) Furthermore, this Regulation should clarify that specificities exclusively related to the national real estate market and its financing should be taken into account during the assessments of the appropriateness of the risk weights or the minimum LGD values in accordance with Article 124 (2) and Article 164 (6) of Regulation (EU) No 575/2013.

(9) Regulation (EU) 2019/876 amending Regulation (EU) No 575/2013 enabled the assessments of appropriateness of risk weights or minimum LGD values to pertain to one or more property segments or parts of the territory of a Member State. This Regulation should, therefore, set out that the types of factors or the conditions laid

down therein may be applied to one or more property segments or to one or more parts of the territory of a Member State. Where data collected in EU harmonised reporting is not sufficiently granular to allow for the assessments of appropriateness of risk weights or minimum LGD values at the level of a property segment or of a part of a territory of a Member State, additional sources of data should be able to be used for such assessment to be enabled.

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

(11) The EBA has conducted an open public consultation 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) No 1093/2010[5].

HAS ADOPTED THIS REGULATION:

Article 1

Types of factors to be considered for the assessment of the appropriateness of the risk weights

1. For the purpose of assessing the appropriateness of the risk weights referred to in Article 124 (2), first subparagraph, of Regulation (EU) No 575/2013, authorities referred to in Article 124 (1a) of that Regulation shall determine:

   (a) the loss experience as the ratio of the following:

      i. in the case of exposures secured by mortgages on residential property as referred to Article 124 (2), first subparagraph, of Regulation (EU) No 575/2013, the losses reported in accordance with Article 430a (1)(a) of that Regulation and the exposure value reported in accordance with Article 430a (1)(c) of that Regulation; and,

      ii. in the case of exposures secured by mortgages on commercial immovable property as referred to in Article 124 (2), first subparagraph, of Regulation (EU) No 575/2013, the losses reported in accordance with Article 430a (1)(d) of that Regulation and the exposure value reported in accordance with Article 430a (1)(f) of that Regulation;

   (b) the loss expectation as the best estimate of losses to be realised during a forward-looking horizon of at least one year and up to three years as further specified by the authority referred to in Article 124 (1a) of Regulation (EU) No 575/2013. The loss expectation shall be determined as the average of the estimated losses for each year during the chosen forward-looking horizon.

2. The loss expectation referred to in point (b) of paragraph 1 shall be determined by either adjusting the loss experience referred to in point (a) of paragraph 1 upwards or downwards, or by keeping the loss experience unchanged, to reflect the forward-looking immovable property market developments referred to in Article 124 (2),

[5] 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, 15.12.2020, p. 12).

first subparagraph, point (b), of Regulation (EU) No 575/2013 during a forward-looking horizon of at least one year and up to three years.

3. The loss expectation referred to in point (b) of paragraph 1 and determined in accordance with paragraph 2 shall be based on the following:

(a) the historical evolution and cyclical characteristics of the immovable property market as reflected in immovable property market transactions and prices, and in the volatility of these prices, evidenced by the relevant data indicators or qualitative information;

(b) the past and present structural characteristics of the immovable property market, and also the future evolution of those structural characteristics. Structural characteristics relate to the size of the immovable property market, the specificities of real estate financing, national taxation systems and the national regulatory provisions for buying, holding or letting immovable property;

(c) the fundamental drivers of demand and supply in the immovable property market, evidenced by any relevant data indicators or qualitative information, such as lending standards, construction activity, vacancy rates, or transaction activity;

(d) the riskiness of the exposures secured by immovable property measured by indicators relevant for the property segments and if relevant to parts of the territory, having regard to Section 6 of the EBA Guidelines on subsets of exposures in the application of a Systemic Risk Buffer (EBA/GL/2020/13) issued in accordance with Article 133 (6) of Directive 2013/36/EU[6] and the lending standard indicators specified in the ESRB recommendation on closing real estate data gaps (ESRB/2016/14);

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

(f) the expected evolution in meaningful macroeconomic key variables that could affect the solvency of borrowers, including an assessment of the uncertainty around these expectations;

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

(h) national specificities related exclusively to the real estate market and its financing, including, public and private guarantee schemes, tax deductibility and public support in the form of recourse regimes and social safety nets;

(i) any other data indicators and sources which provide insight into forward-looking property market developments which impact the loss expectation referred to in point (b) of paragraph 1 or support the data quality of the loss experience referred to in point (a) of paragraph 1.

4. In the case where uncertainty referred to in point (e) of paragraph 3 is high, a margin of prudence in the determination of the loss expectation shall be considered.

[6] 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).

5. When applying paragraph 1, the authorities referred to in Article 124 (1a) of Regulation (EU) No 575/2013 shall have regard to other current macroprudential measures in force, including measures in national law designed to enhance the resilience of the financial system such as, but not limited to, loan-to-value limits, debt-to-income limits, debt-service-to-income limits and other instruments addressing lending standards, that already address the identified systemic risks affecting the appropriateness of risk weights referred in Article 124 (2), first subparagraph, of Regulation (EU) No 575/2013.

Question for consultation:

1. **What is the respondents' view on the types of factors to be considered during the determination of the loss expectation for the appropriateness assessment of risk weights under the SA?**

2. **What is the respondents' view of the option of considering climate related risks in the determination of the loss expectation where the relevant authority was in a position to perform an appropriateness assessment to one or more parts of the territory of the Member State? What would for the respondent be the benefits and the challenges (costs) of such option?**

Article 2

Conditions to be taken into account for the assessment of the appropriateness of the minimum LGD values

1. For the purpose of assessing the appropriateness of the minimum LGD values referred to in Article 164 (6) of Regulation (EU) No 575/2013, the authorities referred to in paragraph 5 of that Article shall, when performing the systemic risk assessment on the basis of macroeconomic imbalances impacting on LGD estimates beyond the economic cycle, have regard to all of the following conditions:

   (a) demand and supply conditions of real estate markets and dynamics in real estate prices, including, where relevant and if a robust estimation is available, the degree of over- or undervaluation of real estate prices;

   (b) conditions that impact on drivers of LGD estimates, including, if relevant, changes in the length and the effectiveness of the process for pursuing recoveries as a result of changes in the recovery procedures, changes in the frequency of the return of obligors or individual credit facilities to non-defaulted status that are caused by changes in unemployment rates or changes in household or corporate debt levels, and interest rates;

   (c) other conditions that indirectly impact on the value of collateral taken into account in LGD estimates, including if relevant loan-to-value (LTV) ratios, cross collateralisation and other common forms of credit protection relevant to retail exposures secured by immovable property in the respective Member State.

2. When applying paragraph 1, the authorities referred to in Article 164 (5) of Regulation (EU) No 575/2013 shall also have regard to the following:

(a) whether the macroeconomic imbalances are related to an economic downturn, and hence are considered in the downturn LGD estimation for the respective exposures;

(b) other current macroprudential measures in force, including measures in national law designed to enhance the resilience of the financial system such as, but not limited to, loan-to-value limits, debt-to-income limits, debt-service-to-income limits and other instruments addressing lending standards, that already address the identified systemic risks affecting the adequacy of minimum LGD values;

(c) the degree of uncertainty around the evolution of immovable property markets and their price volatility;

(d) national specificities exclusively related to the real estate market and its financing, including public and private guarantee schemes, tax deductibility and public support in the form of recourse regimes and social safety nets;

(e) where relevant and available, benchmarking comparisons of LGD estimates across institutions or Member States for comparable portfolios, risk levels and facilities secured by immovable property pledged as collateral.

Questions for consultation:

3. **What is the respondents' view on the conditions when assessing the appropriateness of minimum LGD values (cf paragraph 1 of Article 2)?**

4. **What is the respondents' view on the considerations to be taken into account when assessing the appropriateness of minimum LGD values (cf paragraph 2 of Article 2)?**

Article 3

Assessments for property segments or specific parts of the territory – use of other sources of data

1. The types of factors set out in Article 1 or the conditions set out in Article 2 may be applied by an authority referred to in Article 124 (1a) and in Article 164 (5) of Regulation (EU) No 575/2013 to one or more property segments or to one or more parts of the territory of the Member State of that authority, as appropriate.

2. To determine the loss experience in accordance with Article 1 (1)(a) or the minimum LGD values in accordance with Article 2 for a property segment or a part of the territory of the Member State of an authority referred to in Article 124 (1a) and in Article 164 (5) of Regulation (EU) No 575/2013, other sources of data including national ad-hoc reporting and credit registers relating to that property segment or part of the territory of a Member State may be used, where the data collected in accordance with Article 430 (1)(a) and Article 430a of that Regulation is not sufficiently granular.

Questions for consultation:

5. **What is the respondents' view on the use of other data sources?**
6. **Do respondents want to raise other considerations relevant for the application of this article?**

Article 4
Entry into force

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

5. Accompanying documents

5.1 Draft cost-benefit analysis / impact assessment

This analysis provides the reader with an overview of the findings as regards problem identification, possible options to remove problems and their potential impacts. Both a qualitative and quantitative analysis are provided. The quantitative section is meant to provide the reader with information about the materiality of the exposures secured by mortgages on real estate properties (mortgages hereinafter). Furthermore, this section provides a framework for assessing the implementation of the draft RTS. The qualitative analysis provides a discussion about pros and cons of the requirements set out in the RTS.

A. Problem identification: quantitative analysis

Mortgages represent a substantial share of European institutions' loan portfolios, on average 24% of total Exposure Value.[7,8,9] In 4 out of 26 jurisdictions, mortgages represent more than 1/3 of the Exposure Value (see Figure 1).

The Exposure Value (EV) is the prudential definition of the value of an exposure and this definition differs materially from the applicable accounting definitions. Under the Standardised Approach (SA), the EV is net of credit risk adjustments[10], while under the Internal Ratings Based (IRB) Approach the EV is gross of credit risk adjustments[11]. Both approaches include on-balance sheet exposures and off-balance sheet exposures weighted by the appropriate percentage or conversion factor.[12]

For the quantitative analysis, credit risk adjustments have been added back to the SA EV to align the definition with the one applicable under the IRB approach. On 31 December 2019, 83% of all mortgages were reported under the IRB Approach.

[7] The average is computed as an exposure-weighted average.

[8] The analysis is done on a sample of 118 credit institutions (excluding subsidiaries located outside institutions' country of origin) of 26 EEA states, which report both COREP and FINREP data to the EBA. The reference date of the analysis is 31 December 2019. The analysis considers for the Standardised Approach the exposures that are associated with a weighting factor of 35% or 50% and for the IRB Approach the exposure classes Retail - Secured on real estate property - Of Which: SME and Retail - Secured on real estate property - Of Which: non SME. The total amount of exposures secured by mortgages on real estate properties observed in the sample is EUR 5.2 trillion.

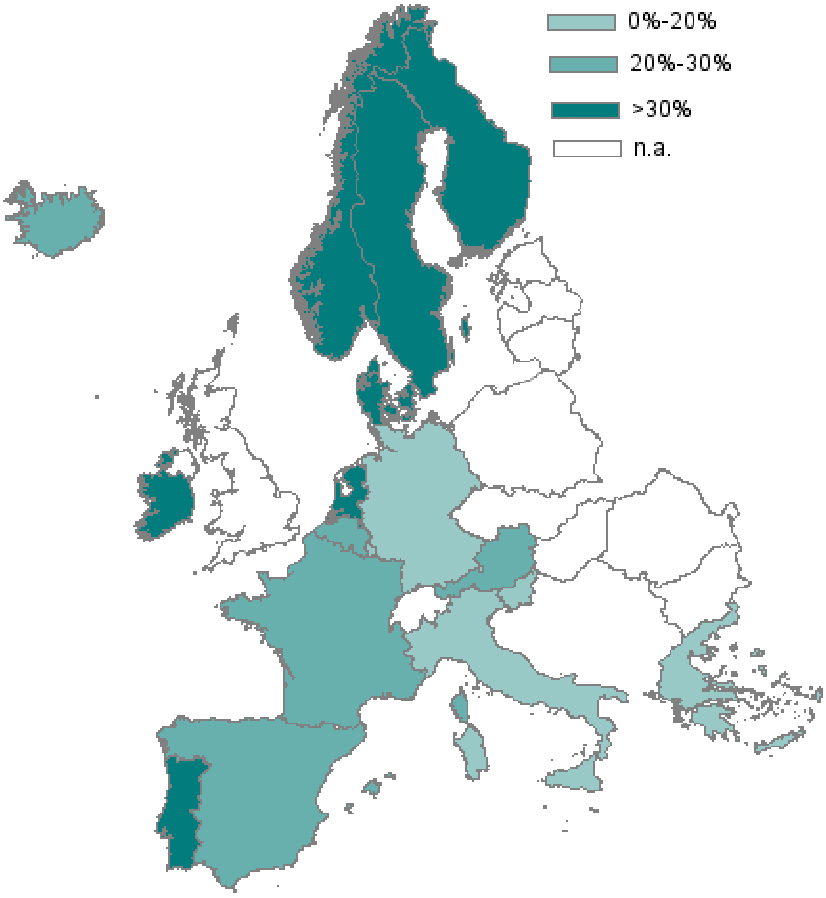
[9] The mortgages classified in default under the SA are excluded as they are not affected by Article 124(2) of the CRR2.

[10] See article 111 of the CRR2

[11] See article 166 of the CRR2

[12] See article 4(56) of the CRR2

***Figure 1**: Share of exposures secured by mortgages on real estate properties on total Exposure Value as of December 2019*



Relative share of loans secured by IP over total Exposure Value

Country	%	Country	%
AT	22.1%	IT	17.2%
BE	26.3%	LT	
BG		LU	14.2%
CY		LV	
DE	12.3%	MT	
DK	38.2%	NL	34.0%
EE		NO	37.4%
ES	28.8%	PL	
FI	32.5%	PT	30.5%
FR	20.9%	RO	
GR	19.2%	SE	38.3%
HU		SI	8.4%
IE	31.2%	All	24.0%
IS	27.1%		

Note: Country data should be interpreted with caution because differences in the representativeness of the sample across countries may affect data comparability. Moreover, the information used represents institutions' portfolios without considering the residence of the obligor.
Countries with less than 3 institutions in the sample are not represented.
Source: EBA Supervisory Reporting and own calculations

B. Policy objectives

The risk weights under the SA, as well as the parameters of the IRB Approach including minimum LGD values are laid down in the CRR. Articles 124 (2) and 164 (6) of the CRR2 provide the relevant authorities with a certain level of flexibility to deal with eventual underestimation of macroprudential risks related to mortgages portfolios, in particular by allowing relevant authorities to increase the risk weights or minimum LGD values set out in the CRR in cases where risk weights or minimum LGD values are found to be not appropriate and that such an inadequacy could affect current or future financial stability of the respective Member State.

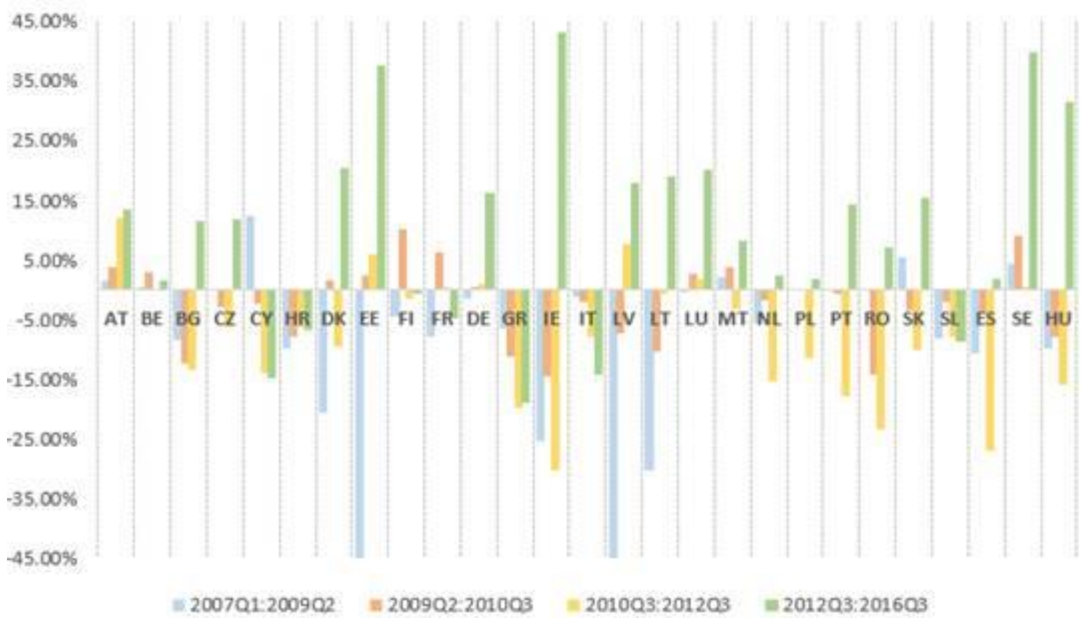
For example, relevant authorities could make use of these provisions in times of potential overheating of the housing markets. Figures 2 shows the dynamic of house prices in the Euro Area between 2005Q1 and 2020Q1.

***Figure 2**: Euro Area House prices – annual rate of change*

Source: BIS Statistics Warehouse[13]

Figure 3 provides, as an illustrative example, the dynamics of prices at country level during and after the 2007-2008 Great Financial Crisis (GFC). These periods show significant variations of the house prices both at the country level within the EU illustrating the heterogeneity of European property markets. From these figures, it can be noticed that European housing markets have faced periods of large price variation although with relatively high country dispersion.

***Figure 3**: House prices, rate of change in the specified periods*



Source: BIS Statistics Warehouse

The objective of the RTS is to provide a sufficiently harmonised framework for assessing the adequacy of risk weights under the SA or the minimum LGD values under the IRB Approach taking

[13] https://stats.bis.org/

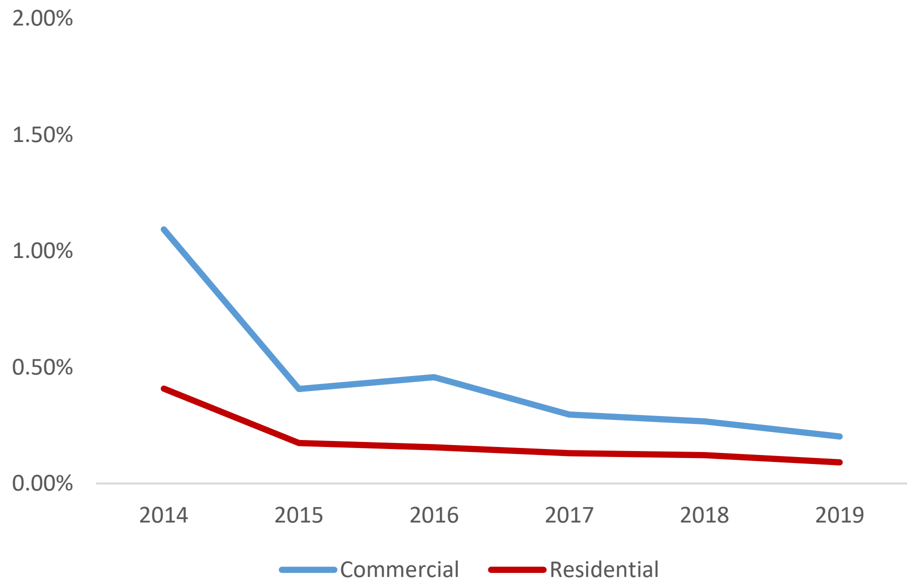
into consideration the heterogeneity of real estate markets in the EU. The RTS require assessing the appropriateness of the risk weights under the SA based on the loss experience (based on the data collected according to Article 430a of the CRR2) and the loss expectations that should be determined according to types of factors. Concerning the minimum LGD values, the RTS requires assessing whether these minimum LGD values are appropriate from a systemic risk perspective beyond the economic cycle.

According to Article 430a of the CRR2 and Article 101 of the CRR, institutions are required to report losses for all defaults on exposures secured by real estate property that occur during the respective reporting period and irrespective of whether the work-out (the recovery process) has been completed during the period or not. More in detail, institutions report all losses stemming from lending collateralised by residential property or by commercial immovable property up to the part of exposure treated as fully and completely secured according to Article 124 CRR.

Figure 4 below depicts the dynamic of the annual loss rate for EU institutions reported as mentioned above for exposures secured by residential properties and exposures secured by commercial properties. Since there may be a long time lag between default and loss realisation, loss estimates are reported in cases where the workout has not been completed within the reporting period. In particular, for IRB institutions, it can be assumed that the loss estimates are based on the estimated LGDs. The data include immovable property financed by foreign institutions (cross border) and foreign branches[14]. This enables, on one hand, to better segment the loss experiences by country and, on the other hand, to observe losses reported from foreign institutions. At the aggregate level, the loss rate observed in 2014 appears higher than what can be observed in the subsequent years.

[14] See Article 430a (2) and 101 (2)

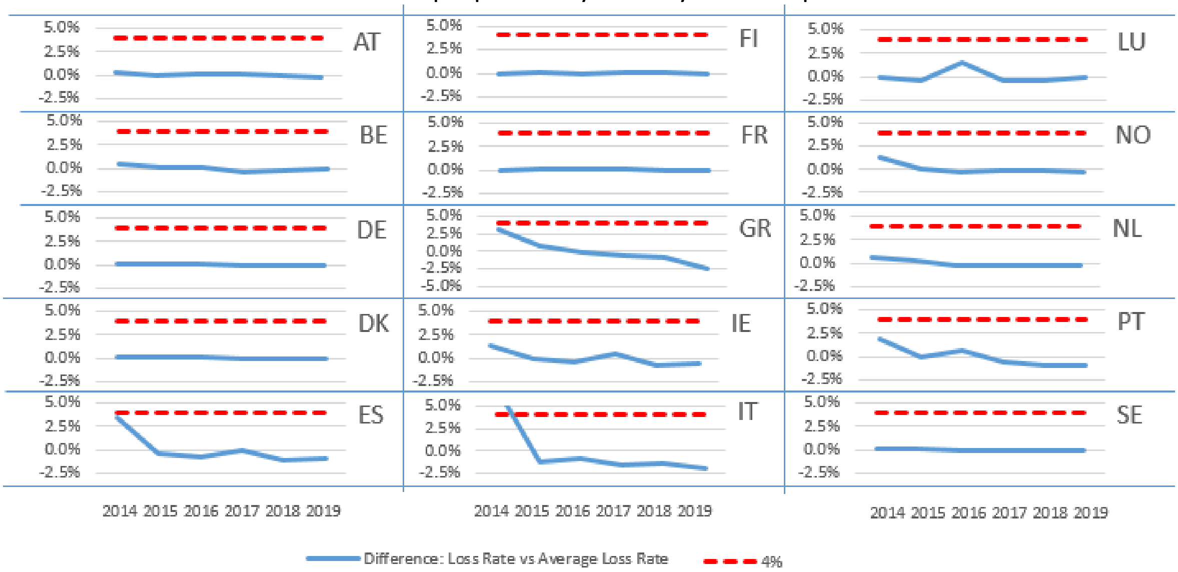
Figure 4*: Annual Loss rate* for exposures fully secured by commercial/residential immovable properties *from data collected under Article 430a of the CRR2 and Article 101 of the CRR*



Source: EBA Supervisory Reporting and own calculations

The RTS require to assess the appropriateness of the 35% and 50% risk weight assigned under the SA to exposures secured by immovable properties, leveraging on the data regarding the loss experiences. For example, it can be noticed that the risk weight of 50% for exposures secured by commercial properties is equivalent to 50%*8% = 4% of minimum required capital (MRC). This means that institutions are required to have, at least, capital to cover losses exceeding the expected loss by an amount equal up to 4% of the EV. This requirement can be compared with the dynamic of the loss rate calculated on the basis of the data under Article 430a of the CRR2 as depicted in Figure 5 for several Member States. In particular, the MRC can be compared with the highest difference between the annual loss rate and the average of the loss rates observed for the parts treated as fully and completely secured in the period.

***Figure 5**: Difference between the annual loss rate and the average of the loss rates observed in the period from data collected under Article 430a of the CRR2 and the minimum required capital (MRC) implied from the risk weight under the SA for exposures* fully *secured by commercial immovable* properties by country of the exposure



Note: Country data should be interpreted with caution because differences in the representativeness of the sample across countries may affect data comparability. Countries with less than 3 institutions in in the sample are not represented. During the period 2014-2019, the macroeconomic development has in general been positive at the EU level which naturally have kept loss rates relatively low. *Source*: EBA Supervisory Reporting (Templates C.15) and own calculations

For the purpose of assessing the appropriateness of risk weights, the draft RTS require to consider the loss expectation. This element should be determined by a set of factors listed in the draft RTS and on the extent to which a factor is deemed to be relevant for the immovable property market of the Member State and available for the relevant authority. Although no single methodology is given in the draft RTS, a possible way (just as an example) of operationalising the link between loss expectation and the set of factors could be by estimating a model correlating these factors with the annual loss rate[15]. This model, in turn, could be used to evaluate the loss expectations under different scenarios.

For what concerns the minimum LGD values, Article 430a of the CRR2 is not referred to in the RTS. The RTS focus more on whether the macroeconomic imbalances in a specific real estate market may affect LGD estimates beyond the economic cycle and how this might render the minimum LGD value inappropriate. This “systemic risk” view beyond the economic cycle is necessary in order to reflect the regulatory requirements regarding the downturn LGD that has to be applied by institutions. For example, it can be noted that imposing a minimum value on the LGD implies, for a given loan to value ratio, a floor on the haircut applied to the value of the immovable property pledged as collateral for the loan. Indeed, given the LGD_{floor}, the maximum recovery (R) expected is:

[15] This is only a simplified example on how to operationalise the link between the types of factors and the annual loss rates. This is not a recommendation nor a policy advice.

$$R = (1 - LGD_{floor})Loan$$

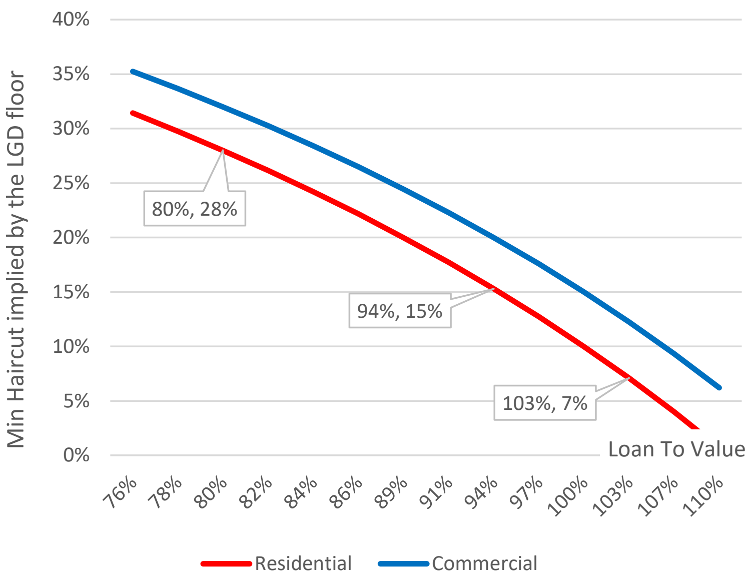
That means that the minimum haircut (H) applied to the value of the collateral can also be derived as:

$$H = 1 - \frac{R}{Value} = 1 - \frac{(1 - LGD_{floor})Loan}{Value} = 1 - (1 - LGD_{floor})LtV$$

where LtV is the loan-to-value ratio.

Figure 6 shows the relationship explained above between the minimum haircut implied by the minimum LGD value and the loan-to-value ratio for retail exposures secured by residential and commercial immovable properties. The minimum haircut could be compared with the expected price change. For example, with a loan-to-value equal to 80%, the 10% LGD floor implies a minimum haircut equal to 28%. This quantity could be interpreted as the potential price fall in an economic downturn before arriving at the minimum loss implied by the minimum LGD value. As the LtV increases, the potential price fall absorption implied by the 10% LGD minimum value reduces.

Figure 6: *Relationship between minimum haircut given the minimum LGD value and LtV*



C. Baseline scenario

Article 124 (2) of the CRR2 allows relevant authorities to increase the risk-weights applied to exposures secured by mortgages under the SA for credit risk. This would directly affect the minimum capital requirements. Article 164 (6) of the CRR2 allows relevant authorities to modify the minimum LGD values set in Article 164 (4), i.e. 10% for residential mortgages and 15% for commercial mortgages. The impact on capital requirements in this case is indirect and would be effective only if the minimum LGD values become binding. However, modifying the LGD as to comply with the eventual modified minimum LGD value would have an impact not only on the RWAs but also on the estimated expected loss amount (EL) and this could shape further impacts on the capital requirements.

The quantitative analysis showed the relevance of the mortgage portfolio and the potential variability of the house prices dynamics at the European level and across countries. These evidences give support to the importance of harmonising - across the EU - the approaches used for the evaluation of the adequacy of the prudential treatment of this portfolio, but also to the necessity of leaving adequate flexibility at country level to address specific characteristics within the real estate market.

The current situation, i.e. the baseline scenario, has been assessed by a survey conducted by the EBA among the competent authorities. This survey revealed the existence of some room for further harmonising current practices. The survey documents a situation of significant heterogeneity in terms of reference data exploited and approaches used. Hence, the reference to the need to use the data collected on the basis of Article 430a of the CRR2 could entail a cost as, according to the survey, not all authorities rely completely on it. On the other hand, the use of a common database would help to increase the harmonisation between the authorities. Moreover, the data collected on the basis of Article 430a is only one of the elements that these draft RTS require to be considered in the assessment of the appropriateness of risk weights.

Also, the provision to formulate a loss expectation on the ground of the set of factors that the draft RTS delineates may entail additional efforts for some authorities. In turn, this could help to foster a better understanding of the motivations behind the eventual decisions on the appropriateness of the actual prudential treatment.

E. Cost-Benefit Analysis

Qualitative Analysis

The EBA has been mandated to develop an RTS to specify the types of factors or the conditions to be considered for the assessments of the appropriateness of the risk weights under the SA or the minimum LGD values under the IRB Approach. There is clearly a trade-off between full harmonisation of the assessments and taking into account national specificities of the real estate markets. This heterogeneity also emerged in the survey conducted by the EBA. This is why the types of factors or the conditions mentioned in this Regulation provide for a mapping of the most used classes of indicators and leave the relevant authorities enough room for manoeuvre in choosing the specific ones on which the abovementioned assessments of appropriateness should be carried out.

The setting of a common framework, in terms of the types of factors or the conditions to be taken into account when applying the discretion granted by Articles 124 (2) and 164 (6) of the CRR2, leaves sufficient flexibility in designing the assessments performed by relevant authorities but simplifies and harmonises the understanding of the reasons motivating actions taken on the basis of the assessments.

The common framework proposed for the appropriateness assessments in the draft RTS rely, where possible, on definitions that are already harmonised in the EU (either CRR or other harmonised legislation). This supports the consistent application of Articles 124 (2) and 164 (6) of the CRR2 across Member States. Allowing Member States to define the conditions for the application of Articles 124 (2) and 164 (6) of the CRR2 without any further guidance would instead increase the complexity.

The availability of databases with harmonised data, as it is based on the same reporting rules, such as the one established on the basis of Article 430a of the CRR2, can help to harmonise the approaches used to assess the adequacy of the current prudential treatment.

It must be noticed that some of the types of factors mentioned in the RTS can only be monitored if appropriate data is available, leading to potential data gaps between Member States.

F. Assesment

In December 2019, the total amount of MRC stemming from mortgages was equal to about EUR 72bn representing 10.3% of overall (i.e. including market risk and operational risk) minimum requirements.[16] As shown above, leveraging on Articles 124 (2) and 164 (6) of the CRR2, material differences in the prudential treatment of mortgages could be introduced between Member States.

The common framework presented in the RTS ensure a harmonised application of the prerogatives set in Articles 124 (2) and 164 (6) of the CRR2. Within the framework delineated by the RTS, the relevant authority can find the right balance between properly assessing the adequacy of risk weights under SA or of minimum LGD values under the IRB Approach from a macroprudential perspective and the flexibility to implement the types of factors or the conditions suitable for its banking sector and immovable property market.

The RTS have benefited from a survey conducted among the Competent Authorities regarding the current practices. On the ground of the analysis of the analysis of this information, it is possible to state that the general principles established by the RTS should not result in a significant increase in costs for the relevant authorities.

[16] Based on COREP data

5.2 Overview of questions for consultation

1. What is the respondents' view on the types of factors to be considered (cf Article 1) during the determination of the loss expectation for the appropriateness assessment of risk weights under the SA?

2. What is the respondents’ view of the option of considering climate related risk in the determination of the loss expectation where the relevant authority was in a position to perform an appropriateness assessment to one or more parts of the territory of the Member State? What would for the respondent be the benefits and the challenges (costs) of such option?

3. What is the respondents’ view on the conditions when assessing the appropriateness of minimum LGD values (cf paragraph 1 of Article 2)?

4. What is the respondents’ view on the considerations to be taken into account when assessing the appropriateness of minimum LGD values (cf paragraph 2 of Article 2)?

5. What is the respondents’ view on the use of other data sources?

6. Do respondents want to raise other considerations relevant for the application of this article?