EUROPEAN ASSOCIATION OF CO-OPERATIVE BANKS
The Co-operative Difference: Sustainability, Proximity, Governance

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**EACB comments on EBA draft RTS specifying the types of factors to be considered for the assessment of appropriateness of risk weights under Article 124 (4) of CRR and the conditions to be taken into account for the assessment of appropriateness of minimum LGD values under Article 164 (8) of CRR (EBA/DP/2021/18)**

## General comments

The EACB welcomes the opportunity to comment on the draft EBA RTS specifying the types of factors to be considered for the assessment of appropriateness of risk weights under Article 124 (4) CRR, and the conditions to be taken into account for the assessment of appropriateness of minimum LGD values under Article 164 (8) CRR.

As a general comment, we believe that caution needs to be exercised when looking at new loans vs the stock. We understand that the EBA mandate in CRR applies to all loans categorized by objective criteria, and that the macroprudential considerations would affect the whole book. Having regard to the EBA mandate, which refers to either the current or future financial stability, we advocate for an approach allowing authorities to consider in their assessment on adequacy (or not) of risk weights also whether the stock may remain subject to the risk weights according to Art 125 (2) or 126 (2) or the applicable risk weight at the time of adjustment according to Art 124 (2) CRR. In fact, it should be noted that property values associated to older loans are likely to have risen in a "natural" manner and not due to macroeconomic imbalances or market overheating, while the outstanding amount of the loans decreased.

We believe that unwarranted increases in risk weights or LGDs should be avoided. Indeed, as mentioned, legacy exposures might be disproportionately affected as their value could be seen as overvalued simply because mortgage loans are concluded with a duration of several decades. Over the time, the collateralization of the exposure will increase as the credit claims is reduced due to repayment and the value of the immovable property will typically be increased.

We encourage the EBA to refine the analysis and take into due consideration this aspect within the text of the RTS.

Q1 *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?*

We believe that the Competent or Designated Authority should bear in mind, and take into consideration in their assessment, the built-in buffer that Art. 125 and 126 CRR determine for exposures fully and completely secured by mortgages when assessing the appropriateness of risk weight for immovable property.

Indeed, Art. 125 (2)(d) CRR requires that the part of the loan to which the preferable 35% risk weight is assigned does not exceed 80% of the market value of the property in question or 80% of the mortgage lending value of the property (residential property). Art. 126 (2)(d) CRR, on the other hand, mirrors this requirement for commercial immovable property, meaning that the preferential 50% risk weight part of the loan must not exceed 50 % of the market value of the property or 60 % of the mortgage lending value.

Therefore, the CRR already requires buffers (20% residential, 50%/40% commercial immovable property) for the value of the property securing an exposure. Even in the event that the residential immovable property market were overheating and real estate became overvalued, existing requirements would ensure prudent capital allocation for the exposures affected.

*A closer look at the CRR mandate*

The mandate given to EBA neither requires the application to all exposures regardless of the time of origination (i.e. before or after the final regulation will be published), nor does it exclude the possibility to increase risk weights or impose stricter criteria only to newly originated exposures (no retroactive application).

The CRR II according to Art. 124 para 4 (and Art. 164 para 8) mandates EBA in cooperation with ESRB to develop Draft RTS to specify inter alia the types of factors to be considered for the assessment of the appropriateness of the risk weights referred to in Art 124 para 2.

Art. 124 para. 2 refers to "*exposures to one or more property segments* secured […]" secured. According to para 2, the authority may increase the risk weights applicable to exposures within the ranges of

- 35-150% for exposures secured by mortgages on residential property;
- 50-150% for exposures secured by mortgages on commercial immovable property;

or impose stricter criteria than those set out in Art 125 para 2 or 126 para 2, where the authority concludes that the risk weights set out in Art. 125 para 2 or Art. 126 para 2 "*do not adequately reflect the actual risks related to exposures to* ***one or more property segments*** *fully secured by mortgages on residential property or on commercial immovable property located in one or more parts of the territory of the Member State of the relevant authority*", and if it considers that the inadequacy of the risk weights could adversely affect "***current or future*** *financial stability in its Member State.*"

Application to stock and new exposures or only new exposures, thus appears like a factor to be considered for the assessment of the appropriateness.

In light of the above, we believe that the co-legislators gave EBA the necessary flexibility to specify among the criteria authorities will use in their assessment, also the possibility to assess whether all exposures should be subject to increased requirements or whether it is sufficient to increase them e.g. just for newly originated exposures.

In general, entities addressed by regulatory requirements should be able to rely on regulatory requirements in application at the time of origination. We thus think it should be possible to limit the assessment only to newly originated loans (after publication of the RTS).

*Adequate reflection of actual risks*

It can be assumed that risk weights and requirements currently applicable sufficiently reflect actual risks for exposures secured by mortgages on immovable property. However, we understand that circumstances in the financial or real economy might swiftly change in the future and authorities must be provided with the right tools to address risks to the financial stability.

Again, when looking at the (in)adequacy of applicable requirements, the level 1 text is quite clear on indicating that consideration should be given to "the current or future financial stability".

A decision to apply to "originating exposures" meaning that the stock will remain subject to the former risk weight and "all exposures including the stock" as the more impactful variant should considered examples of the reflection of “time” as one of the criteria used in their assessment whether increased risk weights are appropriate

Text suggestion to be included in Draft RTS

“*Article 3a Assessments for application regarding the time component*

*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 exposures originated after [insert … e.g. 12 months after publication of the final delegated act in the OJEU] or all exposures taking into account the current or future financial stability in its Member State, as appropriate*.”

Furthermore, we believe that some form of “balancing mechanism” should be introduced. This would mean that where the authority has decided to increase requirements applicable to exposures, an individually identified exposure may not need to be subject to the increased requirements if the institution can demonstrate that the exposure secured by immovable property is oversecured in equal proportion.

E.g.: authority A in member state M decides to increase the risk weight for newly originated exposures fully and completely secured by mortgages on residential property to 70% (instead of 35%, i.e. the base one). The exposure amount is € 400.000 while the market value of the immovable property is € 1 million.

The credit institution may apply a preferential risk weight of 35% (i.e. the base one) for the full exposure as the exposure is oversecured in equal proportion. In fact, if the authority had not increased the risk weight, a market value of € 500.000 would have been sufficient – 80% of the exposure amount, according to Art. 125 para 2 CRR – however, the risk weight has been increased by 100%, therefore in order to have the preferential treatment the market value also has to increase by 100%, meaning the part of the loan to which the preferential 35% risk weight is assigned must not exceed 40% (half of 80%) of the market value.

Furthermore, the EBA Draft RTS refers to the EBA Guidelines on subsets of exposures in the application of a Systemic Risk Buffer (EBA/GL/2020/13) in its Art 1. In this vein, we believe it is crucial that any possible future measure regarding the risk weight of immovable property must be targeted and tailored to the specific sectors where the risk materialise.

*<u>Definition of loss experience</u>*

We also advocate for refining the definition of the loss experience used in the draft RTS in order to ensure that the period used to determine the loss experience is long enough to provide meaningful data, i.e. at least three years.

In our view, a minimum period of three years would ensure that the assessment can be done using stable data and prevent distorting results. However, we believe for the same reason that “statistical outliers” should not be considered or at least the outliers should be taken into account with caution for the assessment of higher risk weight according to the EBA Draft RTS.

Q2 *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?*

We question the appropriateness of including climate related risk considerations in the area as a rather individual measure. Climate risk is being addressed under various workstreams to achieve a holistic approach to its reflection in the prudential framework. Addressing it in the area of RWs and LGDs appropriateness seems premature in light of the thorough work to be carried out on this as per the CRR 2 mandate, and the ongoing development of supervisory tools that will allow taking climate risk into account from a Pillar 2 perspective. A double counting of risks should be avoided.

We understand that the EBA's intention at this stage was rather to collect feedback on whether some aspects could already be considered (e.g. physical risk) when assessing future property developments, but as indicated above, we believe that it is essential to avoid piecemeal measures and preempting the outcome of dedicated workstreams. It should also not be forgotten that the authorities when performing the assessment will take a macroprudential perspective into account, therefore the developments of the real estate markets that will be assessed will have implicitly factored in certain relevant climate dimension.

The Commission considers that financial institutions have a key role in funding the transition, while housing does contribute significantly to GHG emissions. Therefore, authorities should be cautious not to jeopardize the shift towards a green building transition in their assessment on whether increased risk weights or LGDs are appropriate. In the light of the far-reaching initiatives being undertaken in the EU and the commitment of its Member States to mitigate climate change according to the Paris Agreement, granting loans to finance the green transition of the economy is a priority and should not be impaired.

We believe that any increase of risk weights or LGDs for exposures fully and completely secured by mortgages should take this into due account and avoid impairing the credit flow.

Q3 *What is the respondents' view on the conditions when assessing the appropriateness of minimum LGD values (cf paragraph 1 of Article 2)?*

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*Q4 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)?*

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*Q5 What is the respondents' view on the use of other data sources?*

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*Q6 Do respondents want to raise other considerations relevant for the application of this article?*

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