Notification template for Article 124 of the Capital Requirements Regulation (CRR) – Risk Weights

Template for notifying the European Banking Authority (EBA), European Central Bank (ECB) and European Systemic Risk Board (ESRB) of higher risk weights being set for immovable property pursuant to Articles 125(1) and 126(1) CRR or on applying stricter criteria than those set out in Articles 125(2) and 126(2) CRR

Please send/upload this template to:

- macropru.notifications@ecb.europa.eu when notifying the ECB (under Article 5 of the Single Supervisory Mechanism (SSM) Regulation[1]);
- DARWIN/ASTRA when notifying the ESRB;
- eportal.eba.europa.eu when notifying the EBA.

The ESRB will publish the risk weights and criteria for exposures referred to in Articles 125, 126 and 199(1)(a) of the CRR as implemented by the relevant authority. This notification will be made public by the ESRB after the relevant authorities have adopted and published the notified macroprudential measure[2].

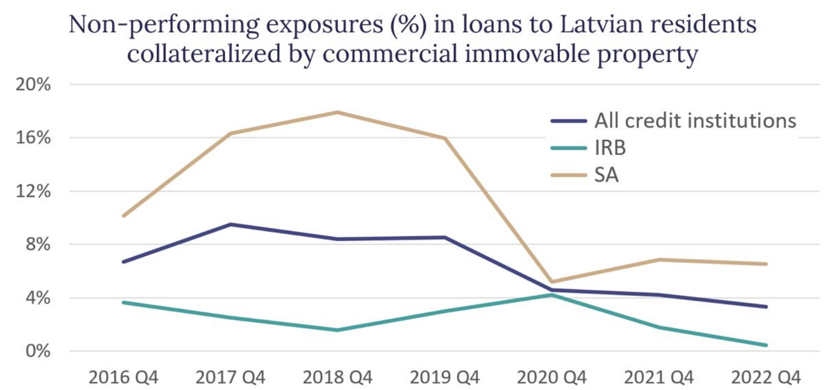
E-mailing/uploading this template to the above addresses constitutes official notification; no further official letter is required. To facilitate the work of the notified authorities, please submit the notification template in a format that allows the information to be read electronically.

1. Notifying national authority	
1.1 Name of the notifying authority	Latvijas Banka
1.2 Country of the notifying authority	Latvia
2. Scope of the notification and description of the measure	
2.1 Exposures secured by mortgages on residential property	a) Do you intend to set a higher risk weight than that set out in Article 125(1) CRR for exposures fully and completely secured by mortgages on residential property? **No** b) If yes, please specify: - Which risk weight you intend to change. Please specify the new risk weight to be set (between 35% and 150%). - To which part(s) of your Member State territory will the new risk weight for exposures set out above apply? - To which property segment(s) will the new risk weight for exposures set out above apply?

[1] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).
[2] On request by the notifying authority, it may be agreed with the Head of the ESRB Secretariat that this notification, or a part thereof, should not be published for reasons of confidentiality or financial stability.

	n/a
	c) Do you intend to apply stricter criteria than those set out in Article 125(2) CRR for exposures fully and completely secured by mortgages on residential property? **No** d) If yes, please specify: - What criteria you intend to add or tighten. - To which part(s) of your Member State territory the stricter criteria set out above will apply? - To which property segment(s) will the new risk weighting for exposures set out above apply? **n/a**
2.2 Exposures secured by mortgages on commercial immovable property	e) Do you intend to set a higher risk weight than that set out in Article 126(1) CRR for exposures fully and completely secured by mortgages on commercial immovable property? **Yes. The risk weight will still remain above the level indicated in Article 126 (1) of the CRR, however, it will be reduced in comparison to the level currently in force in Latvia (100%).** f) If yes, please specify: - What risk weight you intend to set. Please specify the new risk weight to be set (between 50% and 150%). **80%** - To which part(s) your Member State territory will the new risk weight set out above apply? **The risk weight will apply to the whole territory of the Republic of Latvia.** - To which property segment(s) will the new risk weight set out above apply? **The risk weight shall apply to the exposures secured by mortgages on commercial immovable property.**
	g) Do you intend to apply stricter criteria than those set out in Article 126(2) CRR for exposures fully and completely secured by mortgages on commercial immovable property? **No** h) If yes, please specify: - What criteria you intend to add or tighten. - To which part(s) of your Member State territory will the stricter criteria set out above apply? - To which property segment(s) will the new risk weight set out above apply? **n/a**
2.3 Other relevant information	**The actual application of the lowered risk weight by the banking sector will be gradual as currently majority of credit institutions do not classify their commercial immovable property exposures as *exposures fully and completely secured by mortgages on commercial immovable property*. Lowering the applicable risk weight from 100% to 80% will provide an incentive for credit institutions to evaluate if exposures in their commercial property loan portfolios conform to the applicable criteria to be classified as fully and completely secured by mortgages on**

	commercial immovable property, which in our estimation will take up to a year to finalize. .
3. Timing for the measure	
3.1 Timing for the decision	What is the date of the official decision? For SSM countries when notifying the ECB: provide the date on which the decision referred to in Article 5 of the Single Supervisory Mechanism Regulation (SSMR) will be taken. **18/12/2023**
3.2 Timing for publication	What is the date of publication for the notified measure? **19/12/2023**
3.3 Disclosure	Information about the strategy for communicating the notified measure to the market. Please provide a link to the public announcement, if any. **The proposal to decrease the currently applicable risk weight for exposures secured by mortgages on commercial immovable property has already been discussed with the industry. The public communication will be made available on the official website of Latvijas Banka following the decision on 18 December 2023.**
3.4 Timing for application	What is the intended date for application of the measure? **30/06/2024**
3.5 Frequency/review	Does your decision to set higher risk weights have an expiry date? When will the decision be reviewed? **The decision has no set expiry date. The relevant data will be monitored annually, and the risk weight calibration will be reviewed in the future if appropriate.**
4. Reason for setting higher risk weights or stricter criteria than those set out in Articles 125(2) or 126(2) CRR	
4.1 Regulatory context	What are the current risk weights applied to exposures secured by mortgages on residential property and on commercial immovable property? **The 100% risk weight for exposures secured by mortgages on commercial immovable property registered in Latvia has been applied since 2007. For exposures secured by mortgages on residential property risk weight is in line with Article 125 (1) of the CRR.**
4.2 Risk weights versus actual risks	Specify the reasons why the risk weights for 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 your Member State territory do not reflect the actual risks of these exposures and put your answers in perspective vis-à-vis the real estate markets of other European Member States. **The risk weight was originally set at 100% in 2007 due to the small size of the local real estate market that makes the commercial real estate objects less liquid and potentially subject to higher losses and longer recovery periods for credit institutions in case of foreclosure. While this rationale is still relevant, the market liquidity has generally improved and loss rates decreased compared to the period of the global financial crisis and its aftermath.**

	In light of the high uncertainty present in the current macrofinancial environment (incl. any possible future ramifications on the commercial real estate market of Covid-19 pandemic aftereffects and changes in the global interest rate environment) the risk weight is presently being decreased in a precautionary and gradual manner to 80%. Should there be changes in the relevant loss experience data or the macrofinancial environment and its associated risks, the calibration of the risk weight will be reviewed in the future. In the majority of European Union countries (including peer Baltic countries of Estonia and Lithuania) the risk weight for exposures secured by mortgages on commercial immovable property remains set at 50% in line with Article 126 (1) of the CRR.
4.3 Motivation	<u>a) Loss experience</u> - Provide details about the loss experience in the real estate market of your Member State that has led you to conclude that higher risk weights must be set or stricter criteria applied than those set out in Articles 125(2) and 126(2) CRR. **Available data on loss experience at the current juncture is of limited value, as the relevant COREP reporting does not cover a full financial cycle and contains data only for few credit institutions. As the chart below illustrates, available supervisory data on the proportion of non-performing exposures in a wider exposure subset of all loans to Latvian residents collateralized by commercial immovable property suggests increasing credit quality of underlying exposures in recent years, especially in case of SA banks.**  *Sample includes branches of credit institutions registered in other Member States and is divided into credit institutions using standardised approach (**SA**) and internal ratings based approach (**IRB**) for calculation of credit risk capital requirements.* *Source: FINREP F 20.04, Latvijas Banka calculations* **Our analysis of granular exposure data in the national credit register also supports this narrative of an overall decreasing but still heightened risk of exposures that in our assessment could be classified as fully and completely secured by mortgages on immovable property. While we estimate that such exposures held by two credit institutions that employ internal ratings based approach for the calculation of credit risk capital requirements (IRB banks) tend to be of a slightly higher credit quality than those of their standardised approach counterparts (SA banks), implied risk weights for those exposures in IRB banks loan portfolios are also on average lower than the 80% risk weight to be set for SA banks.** - Which of the data referred to in Article 430a CRR were considered in your assessment?

Credit institutions shall report losses in accordance with Article 430a (1)(d) of CRR and the exposure value in accordance with Article 430a (1)(f) of CRR as part of their supervisory reporting obligations in COREP C 15.00. However, as the 100% risk weight requirement has been in force since 2007, there have been scarce incentives for SA banks to classify their commercial immovable property exposures as exposures fully and completely secured by mortgages on commercial immovable property - as of 2022Q4 only 4 out of 13 local credit institutions reported any such exposures (and only one credit institution reported losses) in COREP C 15.00.

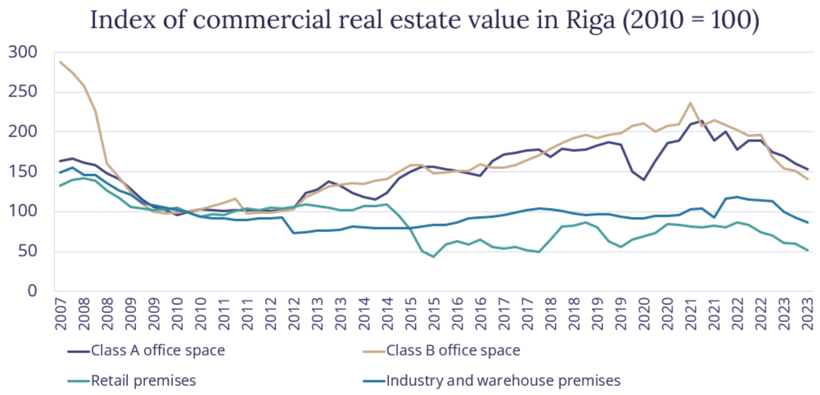
Accordingly, as the supervisory reporting provides only a limited value for the loss experience analysis, in addition to it we also employ the data from the national credit register, where granular information is available for each exposure regarding its size, location, provisions etc.

- Provide any other indicators and other relevant information on the basis of which the assessment was made. If possible, please provide the data (preferably in an Excel file).

b) Forward-looking real-estate market developments

- Describe the forward-looking real-estate market developments that led you to conclude that higher risk weights should be set or stricter criteria applied than those set out in Articles 125(2) and 126(2) CRR.

The chart below displays commercial property market developments for various segments in the capital city (which accounts for the majority of the total exposures) based on the index of commercial real estate value calculated by Latvijas Banka. We can observe a significant negative fluctuation around the period of global financial crisis and its aftermath in 2007-2009. The volatility has decreased since then, with the exception of few recent years affected by Covid-19 pandemic. While credit institutions have so far displayed resilience against these developments (and also against effects of recent changes in the interest rate environment) affecting the commercial property market, we still identify vulnerabilities affecting this subset of credit institutions exposures, though they are less pronounced than in 2007 when 100% risk weight was implemented, thus the gradual decrease to 80% being implemented now.



Source: Colliers International Advisors, Latvijas Banka calculations

Currently there is a comparatively low activity in the commercial real estate market which slightly hinders price discovery. While we see a

potential for a further price correction as the economic actors continue to adjust to the changed interest rate environment, the price growth in years since the global financial crisis has been overall moderate, therefore severe market downturn is unlikely. Nevertheless, as it takes some time for the effects of price changes to fully manifest themselves in credit institution balances, we will continue to monitor the situation closely and adjust the applied risk weight if appropriate.

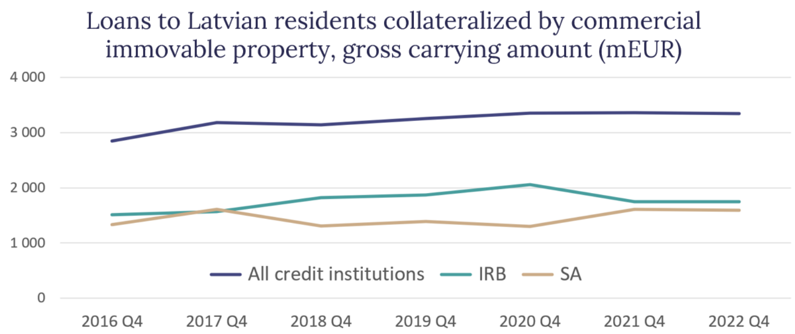
- Provide the indicators and any other relevant information on the basis of which the assessment was made. If possible, please provide the corresponding data (preferably in an Excel file).

<u>c) Financial stability considerations</u>

- What are the financial stability considerations that were taken into account?
- Please include:
  - the factors that could ‘adversely affect current or future financial stability’ as referred to in Article 124(2)(2) CRR; and,
  - the indicative benchmarks that you took into account in determining the higher risk weights.

Commercial real estate constitutes a significant share of the local lending – as of 2022Q4 credit institutions (incl. branches registered in other Member States) had issued in terms of the total gross carrying amount 3.3bn EUR (SA banks - 1.6bn EUR) in loans to Latvian residents collateralized by commercial immovable property representing 53% (SA banks - 54%) of the total resident non-financial corporations loan portfolio. Our estimations based on the analysis of the national credit register data suggest that out of that 1.6bn EUR figure SA banks could potentially be able to classify up to 1.3bn EUR of loans as fully and completely secured by mortgages on commercial immovable property.

As the chart below illustrates, for a wider exposure subset of all loans to Latvian residents collateralized by commercial immovable property there has been a very limited growth in recent years. This is markedly different from the period of rapid credit growth in years up to 2007 when the 100% risk weight requirement was originally set and supports the narrative of overall improved credit quality of underlying exposures.



*Sample includes branches of credit institutions registered in other Member States and is divided into credit institutions using standardised approach (**SA**) and internal ratings based approach (**IRB**) for calculation of credit risk capital requirements.*

Source: FINREP F 20.04, Latvijas Banka calculations

- Provide the indicators and any other relevant information on the basis of which the assessment was made. If possible, please provide the data (preferably in an Excel file).

	- **Latvijas Banka regularly performs stress tests to assess the ability of credit institutions to withstand adverse macroeconomic developments and unexpected losses. The recent exercise based on the end-2022 data (see pages 39-44 of *Latvijas Banka 2023 Financial Stability Report* for more details) included, among other parameters, an assumption for stress scenario of 40% haircut applied to commercial real estate (vs. 20% haircut in the baseline scenario). The results of the stress test, in light of conservative choice assumptions for both scenarios, demonstrate an overall good resilience of credit institutions to withstand economic shocks. Under the stress scenario the losses were estimated at 3.6% of credit institutions assets (vs. 0.9% under the baseline scenario), with losses from the credit portfolio constituting 45.7% of the total.**
5. Sufficiency, consistency and non-overlap of the policy response	
5.1 Sufficiency of the policy response	For a macroprudential policy to be 'sufficient', the policy responses must be deemed to significantly mitigate, or reduce the build-up of, risks over an appropriate time horizon with a limited unintended impact on the general economy. Note that the ESRB will use the assessment of the macroprudential stance as relevant input in assessing the sufficiency of the macroprudential policy in the Member State. Please provide any additional information that the ESRB should consider in assessing the sufficiency of the policy response. **We consider the application of the instrument to be sufficient, as lowering of the applicable risk weight to 80% reflects our assessment of decreased vulnerabilities affecting exposures secured by mortgages on commercial immovable property compared to the situation in 2007 when a 100% risk weight requirement was implemented. Lowering of risk weight is implemented in a precautionary and gradual manner in view of existing high uncertainty as described in Section 4.2. and will be further reviewed in the future. While current measure lowers the loss absorbency requirements for this particular subset of exposures, when viewed together with the parallel implementation of the positive neutral countercyclical capital buffer (PN CCyB) as described in Section 5.3, it represents an overall tightening of our macroprudential stance.**
5.2 Consistency of application of the policy response	For a macroprudential policy to be 'consistent', the policy instruments must be deemed to meet their respective objectives, as outlined in ESRB/2013/1[3], and they must be implemented in accordance with the common principles set out in the relevant legal texts. Note that the ESRB assessment of consistency will consider whether the same systemic risks are addressed in a similar way across and within the Member States over time. Please provide any additional information that the ESRB should consider in assessing the consistency of the policy response.

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

<table>
<tr><td></td><td>We consider the application of the instrument to be consistent as it has since its implementation in 2007 proved to be effective in ensuring prudent risk management by credit institutions and increased loss absorbency for a subset of exposures in relation to which heightened vulnerabilities have been identified. Other Member States that experience comparable commercial property market developments and identify similar vulnerabilities have also set higher risk weight for immovable property pursuant to Article 126 (1) of the CRR.</td></tr>
<tr><td>5.3 Non-overlap of the policy response</td><td>For a policy instrument to be ‘non-overlapping’, it should aim to address a systemic risk that either differs from a risk addressed by other active tools in the same Member State, or be complementary to another tool in that Member State which addresses the same systemic risk.

- Are other policy instruments used to address the <u>same</u> systemic risk?
- If yes, please explain the need for more than one instrument to address the same systemic risk and how the different instruments interact with each other

Currently no other policy instruments are applied that address the same systemic risk. However, in parallel to this measure, PN CCyB is being implemented that will amount to 1% when fully phased-in from June 2025. While PN CCyB targets a broader scope of credit exposures, both of these measures in principle aim to build up the loss absorbing capacity to protect the banking sector from the negative effects of downturns in property market and/or financial cycle.

We deem both instruments to be necessary, as while the implementation of PN CCyB allows to increase in a timely manner the resilience of the banking sector against cyclical downturns that may affect a broad range of relevant credit exposures, application of a risk weight higher than indicated in Article 126 (1) of the CRR for exposures secured by mortgages on commercial immovable property, in turn, enables ensuring additional loss absorbency for a targeted subset of exposures where particular vulnerabilities have been identified, as described above.

While these instruments have slightly different mechanics (increase of a combined buffer requirement vs. decrease of a total risk exposure amount (TREA)), they both affect the amount of capital that credit institutions are required to hold. In our estimation, for SA banks, lowering the applicable risk weight from 100% to 80% will on average counteract (once credit institutions will have reclassified relevant exposures as described in Section 2.3) up to a half of the effect of increased loss absorbency demand resulting from the application of 1% PN CCyB. The cumulative effect of both of these measures will be tightening.</td></tr>
<tr><td colspan="2">6. Cross-border and cross-sector impact of the measure</td></tr>
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6.1 Assessment of cross-border effects and the likely impact on the Internal Market **(Recommendation ESRB/2015/2[4])**	Assessment of the cross-border effects of implementation of the measure. a. Assessment of the spillover channels operating via risk adjustment and regulatory arbitrage. The relevant indicators provided in Chapter 11 of the ESRB Handbook on Operationalising Macroprudential Policy in the Banking Sector[5] and the Framework to assess cross-border spillover effects of macroprudential policies of the ECB Task Force on cross-border spillover effects of macroprudential measures can be used. b. Assessment of the: ○ cross-border effects of implementation of the measure in your own jurisdiction (inward spillovers); ○ cross-border effects on other Member States and on the Single Market of the measure (outward spillovers); ○ overall impact on the Single Market of implementation of the measure **Any cross-border effects and impact on the Internal Market are expected to be minimal given the small size of the local commercial real estate market, incremental nature of the measure (the applicable risk weight is lowered by 20%) and the limited volume of current cross-border mortgage lending.** ○ .
6.2 Assessment of leakages and regulatory arbitrage within the notifying Member State	Referring to your Member State's specific characteristics, what is the scope for "leakages and regulatory arbitrage" in your own jurisdiction (i.e. circumvention of the measure/leakages to other parts of the financial sector)? **We do not expect any material internal leakages or regulatory arbitrage as the structure of the Latvian financial system is heavily bank-dominated and the effect of the measure is incremental (the applicable risk weight is lowered by 20%).** Is there scope for "leakages and regulatory arbitrage" in other jurisdictions? **In our view the scope for leakages and regulatory arbitrage in other jurisdictions is limited in light of the small size of the local commercial real estate market and the incremental effect of the measure (the applicable risk weight is lowered by 20%)**
7. Miscellaneous	
7.1 Contact person(s)/mailbox at notifying authority	Contact person(s) (name, phone number and e-mail address) and mailbox for further inquiries. **Arnis Jankovskis** **+371 29606699** **arnis.jankovskis@bank.lv**
7.2 Any other relevant information	

[4] Recommendation of the European Systemic Risk Board of 15 December 2015 on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures (ESRB/2015/2) (OJ C 97, 12.3.2016, p. 9).
[5] Available on the ESRB's website at www.esrb.europa.eu.

7.3 Date of the notification	Please provide the date on which this notification was uploaded/sent. **04/12/2023**