Consultation template for Article 124 CRR

Template for consulting the EBA on setting higher risk weights for immovable property or applying stricter criteria than those set out in Article 125(2) and Article 126(2) CRR

1. Consulting national authority (If several designated authorities, please mention all of them)	
1.1 Name of the consulting authority	**Croatian National Bank (CNB)**
2. Application of higher risk weights or stricter criteria than those set out in Article 125(2) and Article 126(2) CRR	
2.1. Exposures secured by mortgages on residential property	a) Do you intend to set higher risk weights for exposures secured by mortgages on residential property? **No, but it is currently under review.** b) If the answer to question a) is yes, which risk weight would you set? Please specify the new risk weight (between 35% and 150%).
	c) Do you intend to apply stricter criteria than those set out in Article 125(2) CRR (exposures fully and completely secured by mortgages on residential property)? **No, stricter criteria to exposures secured by residential real estate are already applied.** d) If the answer to question c) is yes, which additional or stricter criteria would you set?
2.2. Exposures secured by mortgages on commercial immovable property	e) Do you intend to set higher risk weights for exposures secured by mortgages on commercial immovable property? **Yes** f) If the answer to question e) is yes, which risk weight would you set? Please specify the new risk weight (between 50% and 150%). **100%**
	g) Do you intend to apply stricter criteria than those set out in Article 126(2) CRR (exposures fully and completely secured by mortgages on commercial immovable property)? **No** h) If the answer to question g) is yes, which additional or stricter criteria would you set?
3. Motivation for setting higher risk weights or stricter criteria than those set out in Article 125(2) or Article 126(2) CRR	

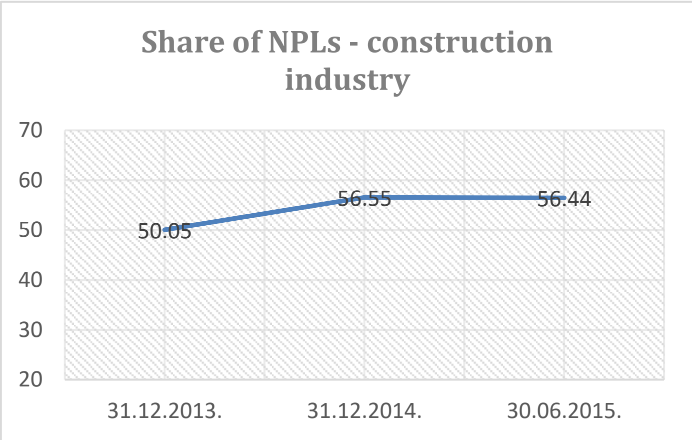
3.1. Regulatory context	• What was the risk weight applied to exposures secured by mortgages on residential property and commercial immovable property before January 2014? **35% - residential properties but only if certain stricter criteria were fulfilled. The criteria applicable during the period 2010 - 2013 were equivalent to stricter criteria which have been in force since January 2014.** **50% - commercial properties** • Is the objective of setting of higher risk weights or stricter criteria under Article 124 CRR a continuation of the previous regulatory treatment of residential and commercial property exposures? **Yes – for residential immovable property** **No - for commercial immovable property** • Do you apply a similar measure in the context of real estate exposures under Article 164 CRR? **No. For the purpose of mitigating risks arising from exposures secured on commercial immovable property, the CNB considers measures to be applied in the context of Article 164 of the CRR not relevant for Croatian financial system. The reasons are twofold:** **1. Article 164(5) of the CRR provides that only the minimum LGD values for all retail exposures are set at higher levels than those prescribed in Article 164(4) of the CRR. It is our opinion that there are no material retail exposures secured by commercial immovable property.** **2. only one credit institution in Croatia calculate capital requirements by using the IRB approach.**
3.2. Risk weights versus actual risks	• Does the risk weight of all residential or commercial property segments reflect the actual risks related to these exposures, fully and completely secured by mortgages on residential property or commercial immovable property? **No, it is the opinion of the CNB that the risk weight of 50% under the standardised approach for exposures fully and completely secured by mortgages on commercial immovable property, does not reflect the actual risk arising from these exposures.** • If not, specify the reasons and the property segments to which this applies, and put your answers in perspective to the real estate markets of other European countries. **Based on reasoning presented further, we consider that no segment of commercial property in the moment fulfils criteria for risk weight of 50%.**

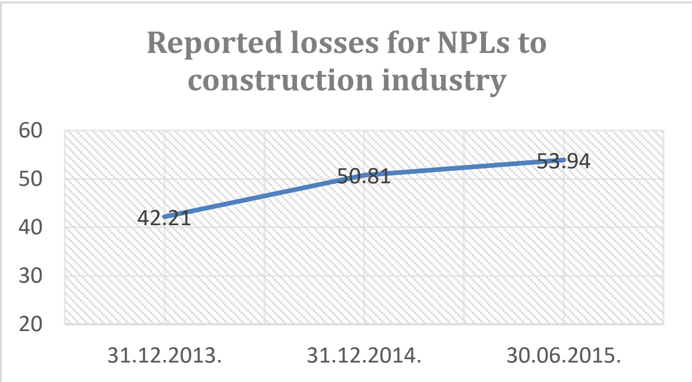
3.3. Motivation

a) Loss experience

- **Give details about the loss experience in the real estate market of the Member State that justify the setting of higher risk weights or the application of stricter criteria than those in Article 125(2) and Article 126(3) CRR.**

On 30th of September 2014 in the category of Exposures secured by mortgages on commercial immovable property Croatian banks reported the value of exposure of 7,96 billion kuna (aprox. 1,06 billion €). Based on the FINREP data for June 30th 2015 Croatian banks reported 3,2 billion € of loans and advances to non-financial corporations secured by commercial real estate, out of which 34,11% were NPLs. Based on aggregated non-consolidated data loans to construction industry on the same date amounted 2,7 billion €, of which 56,44% were NPLs. The losses reported for those NPLs were 53,94%.





These numbers are consequence of long and strong negative trends in the commercial real estate market and the state of economy in general. Due to illiquidity of the market in question Croatian national bank (CNB) expressed concerns that the qualitative criteria prescribed in CRR for using preferential 50% risk weight for this type of exposures in this market is not fulfilled. It is worth mentioning that due to the same reasons 16 out of 33 banks operating in Croatia never used 50% risk weight for this type of exposures. After receiving the letter from the Croatian national bank expressing the concern in December 2014 the remaining 17 banks in Croatia stopped using 50% risk weight for this type of exposures.

	On the 30th of June 2014 CNB received the first report "Exposures and losses from lending collateralised by immovable property" (CR IP LOSSES) in which banks reported "Sum of losses stemming from lending up to the reference percentages" (Column 010) of 24,04 million kuna (aprox. 3,2 million €). Since there was no clear instructions on the data to be reported in the "Sum of the exposures" column 050, some banks reported all of the exposures in the category in question and some only the defaulted exposures from that category. The reported amount was in total 1,3 billion kuna (aprox 0,17 billion €), or 572 million kuna (aprox. 76,27 million €). The reported losses thus were 1,85% if referenced to the total amount, and 4,2% if referenced to the defaulted exposures for which the losses were reported. - **Which of the data mentioned in Article 101 CRR did you use?** The data mentioned in Article 101 CRR were available from 30th of June 2014. Since from the 31st of December 2014 the banks in Croatia stopped using this category only 5 banks reported data on losses on that date (2,56% of the sum of the exposure) and 3 banks on 30th of June 2015 (0,1% of the sum of the exposure). We consider that the data in CR IP LOSSES is of limited value when assessing appropriate standard method risk weights for commercial real estate exposures since they refer to rather recent loss experience and instructions are not yet fine-tuned. That is why we would rather rely on the survey data which CNB performed, and which clearly show that although banks are requiring robust LTV ratios when approving loans secured by commercial real estate they manage to realise less than 50% of the amount of loan left to collect through foreclosure (banks have reported losses of 52% of the amount left to collect through foreclosure). - **Which other indicators have been taken into account?** To obtain information on the actual liquidity of commercial real estate property and assess whether such property may be considered as adequate collateral Croatian national bank conducted a survey in autumn 2014. Banks were forwarded a questionnaire requesting information on exposures secured by mortgages on commercial real estate property. The questionnaire focused on exposures or parts of exposures that had been, or still were, secured by mortgages on or fiduciary transfer of ownership of commercial real estate property for which a bank had initiated legal actions to collect its claims (exposures) by activating such collateral instruments in the period from 1 January 2008 to 31 August 2014. The results of the survey were as follows: • the recoverability ratio (ratio of the total sale price to the estimated value) for 17% of successfully foreclosed properties stands at 55.02%, i.e. that is the average realised value of the properties sold and assumed by the banks. Real estate properties which a bank assumed at a price that was not offered at the market are also considered as collected. It is expected that the real recoverability ratio would have been much lower; • at the banking system level, sale is still in progress for 2,961 properties as at 31 August 2014, which is 82% of all commercial real estate properties for which enforcement actions have been initiated in the last 6 years. Thus suggesting that most of the remaining property might be of lower quality and have serious problem with liquidity

which will entail significantly higher losses then observed.

Further to the survey on foreclosure and realisation of commercial property CNB has conducted a survey on the perception of price fluctuation. Most of the respondents are of the opinion that prices of the commercial property in the period from 2008 to 2014 fell by 35%, and that majority of them expect further reduction in prices by up to 10%. Taking into consideration legal costs and cost of real estate maintenance, if such expectations are correct, principal of average commercial real estate loan wouldn't be collected even if it is collateralised 200%.

We have reasons to conclude that the reported incurred losses of approximately 1,8% (according to IP losses methodology) would be further increased due to deep illiquidity of the market in question and further drop in the property prices and we expect them to breach the 2% limit. Based on the arguments cited in the previous paragraphs we believe that incurred and expected losses for exposures secured by commercial property are well over 2%.

b) Forward-looking real estate market developments

Lacking official statistics on commercial real estate (CRE) transactions, it is difficult to assess historical trends in real estate market and consequently make use of it for the purpose of statistical modelling as well as for producing forecasts. Therefore the Croatian National Bank has conducted ad hoc survey covering a small sample of active real estate agencies that advertise CRE sales. The survey results show that illiquidity of CRE properties in Croatia is high. Most of the respondents are of the opinion that in 2014 the market hasn't shown noticeable signs of recovery and don't expect change of the trend in 2015. So during the 2015, the agencies don't expect any significant recovery of the market and predict further decline of CRE prices (the interval of answers: -10% to 2%).

The survey on collection process (mentioned earlier) also showed that in the period from 1 January 2008 to 31 August 2014 banks have initiated legal actions to collect claims based on commercial real estate property collateral with respect to 3,579 commercial real estate properties. Out of the initiated collection procedures only 618 properties (17.27% of the total) were realised in the reviewed period, of which 322 properties (52.1%) were assumed by the banks themselves; this also suggests that liquidity of commercial real estate properties in Croatia is extremely low.

Croatian National Bank regularly monitors residential real estate prices. Currently available data, based on the number realised transactions (controlled for cyclical factors), characterize the residential real estate market as illiquid. Based on this information, a specific regression model was estimated to extrapolate historical movements in residential real estate prices. The results of this model point to a possible further decrease in residential real estate prices in 2016 and the continuation of this trend in 2017. However, it should be noted that the confidence interval for the model is quite large and that the connection between residential and commercial real estate prices in Croatia is not formally tested.

c) Financial stability considerations

	Croatian National Bank conducts stress testing of credit institutions on a semi-annual basis in order continuously to monitor changes in business conditions and systemic risks, and the ability of credit institutions to withstand unexpected losses that could generate those risks and thus threaten system stability. However, due to commercial real estate data limitations, such analysis include only the shock associated with residential real estate prices. The available statistics for the residential real estate show that the domestic real-estate market is characterized by low turnover which complicates the exercise of collateral and increases risks to the financial system arising from non-performing loans. Both systemically important banks and banks of smaller systemic importance are exposed to these risks (estimates of expected loss where suggest that they have a potential to be harmful for functioning of the financial system). These risks are addressed through systemic risk buffer (SRB) and supervisory decision on stricter criteria for 35% risk weight. It is important to note that the SRB is not used for the purpose of targeting cyclical downturn in the real estate market, but rather to build capacities to cope with problems arising from long-term characteristic of domestic real-estate market that contribute to low levels of market liquidity and riskiness of real estate collateral in general. Further resolution of loans secured by commercial real estate would inevitably rely on bringing significant part of those real estate on the market. Since CRE market characterise very low elasticity of demand which consequently lead to long time for demand to adapt to an abundant supply we expect prolonged echoes of the recent economic crisis on this particular market. As the value consist 7% of Croatian GDP, it would create long lasting overhang on real estate market, probably on some of those estates cause extremely high loss rates. For others, period of collection would be uncertain. Since negative developments in this sector can have a material impact on economic growth and financial stability we consider that it is not appropriate in a current economic situation in Croatia to allow lower risk weight for this type of loans.