1. 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	The Financial Supervisory Authority of Norway (FSA of Norway).
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 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 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)?* Yes h) *If the answer to question g) is yes, which additional or stricter criteria would you set?* The FSA of Norway requires that the institutions have sufficient expertise to evaluate 126(2) a-b. In Norway, institutions using the standardized method are mainly small regional banks operating in densely populated areas. Loans secured by commercial real estate will in many cases be corporate loans to small business secured in shop-, storage-, or manufacturing premises that have limited value in the case of a borrower bankruptcy, either because the property is unsuitable for other uses, or because the bankruptcy is due to an adverse regional development

	that makes alternative use of the property difficult (e.g. depopulation/deindustrialization). Thus the criterion in CRR- Article 126 (2a) will in many cases not be met. In the cases that a standard method bank finances real estate firms directly, the borrower will often be an SPV or a small commercial company where the property is a significant part of the borrower's total assets. In these cases, often CRR Article 126 (2b) cannot be fulfilled. FSA Norway recognize that the standard method banks may have certain exposures that qualify for the criteria in 126 (a and b), but is doubtful as to the appropriateness of the criteria to be assessed on a case-to case basis, given the banks' size, expertise, and recognizing that the criteria in any case are very hard to assess with any precision. The FSA of Norway opines that requiring the institutions to have sufficient expertise to assess 126 (2) a-b will in effect rule out the possibility for Norwegian standard method banks to use lower risk weight than 100 percent.
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?* 100 % - *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. The 100 % risk weight on exposures secured by commercial property, which was implemented in Norway in 1989 as a part of the implementation of Basle I compliant regulation, was continued when implementing 98/32/EC and 98/33/EC in 2001, and later when implementing 2006/48/EC and 2006/49/EC in 2006. At each occasion the opportunity to set lower risk weights was rejected after thorough analysis, and on the basis of roughly the same arguments (the relevant documents may be provided EBA on request). - *Do you apply a similar measure in the context of real estate exposures under Article 164 CRR?* No. However, own values of LGD are required to reflect a degree of severity for a downturn comparable to the Norwegian banking crisis (1988-1992). Furthermore, long term outcome for PD is required to be adjusted to an average which includes the banking crisis, where bank losses were dominated by losses on commercial real estate. Thus, a similar degree of conservatism applies for the risk assessment of commercial real estate for exposures in Norway under the IRB-method.
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 FSA of Norway that the risk weight of 50% under the standardised method, for exposures fully and completely secured by mortgages on commercial immovable property, does not reflect the actual risk going forward. - *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.

The loss experience on commercial property lending in Norway indicates that risk is extremely volatile. Whilst in normal years, losses on commercial property can be very low, in crisis periods they have shown to dominate total loan losses completely, c.f. section 3.3-a. This is the experience of also other European countries. However, particular for Norway is the small size of the standard method banks. Norway has a bank sector with a small number of large and medium sized banks using the IRB method and a great number of very small rural banks using the standardized method (the median total assets of the standard method banks is only EUR Mill. 375). Both the fact that they are small, and that lending is concentrated in rural areas makes it difficult for the banks to evaluate CRR Article 126(2) a-b. It is the experience of the FSA of Norway that also the valuation of real estate premises are challenging for the smaller banks, and in particular in the face of shifting economic environments and regional developments.

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.*

Considering the acknowledgement that the full loss potential in commercial real estate lending is revealed in times of severe crises, the FSA of Norway considers the period surrounding the Norwegian banking crisis (1988-1992) to be the most relevant. Loan losses in percent of lending are illustrated for commercial real estate and for the full lending portfolio for Norwegian savings banks in figure 1, and for the Norwegian commercial banks in figure 2. During the banking crisis the increase in commercial real estate losses was significantly larger than the portfolio as a whole. Figure 3 shows the development in the real price of office premises in Oslo and Bergen (1999-NOK per m^2). From 1987 to 1996 average office prices fell almost 60 per cent in real terms. Over the last 10 years prices have grown substantially in both Oslo and Bergen.

Figure 1: Loan losses in percent of lending. Norwegian Savings banks

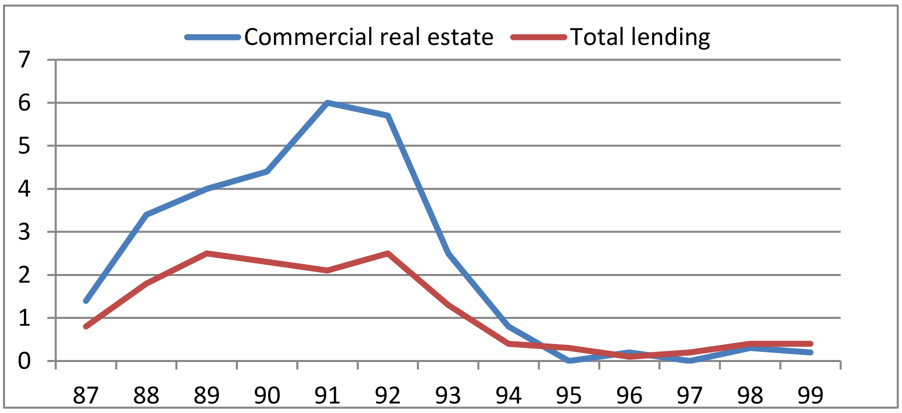


Figure 2: Loan losses in percent of lending. Commercial banks

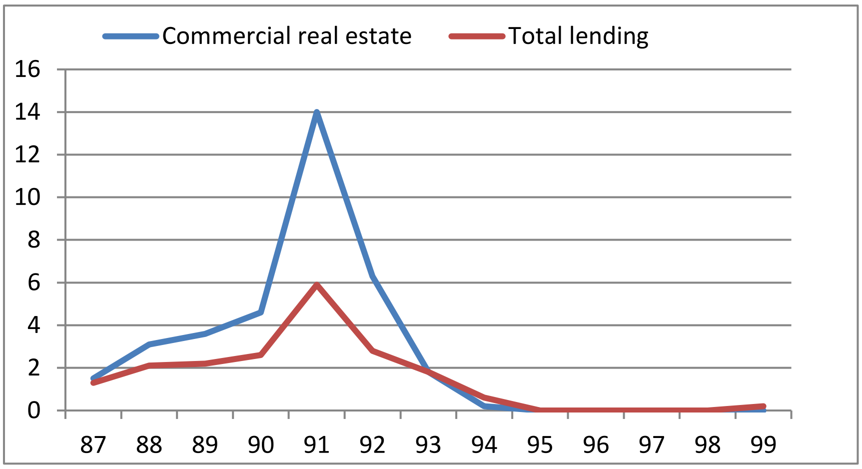
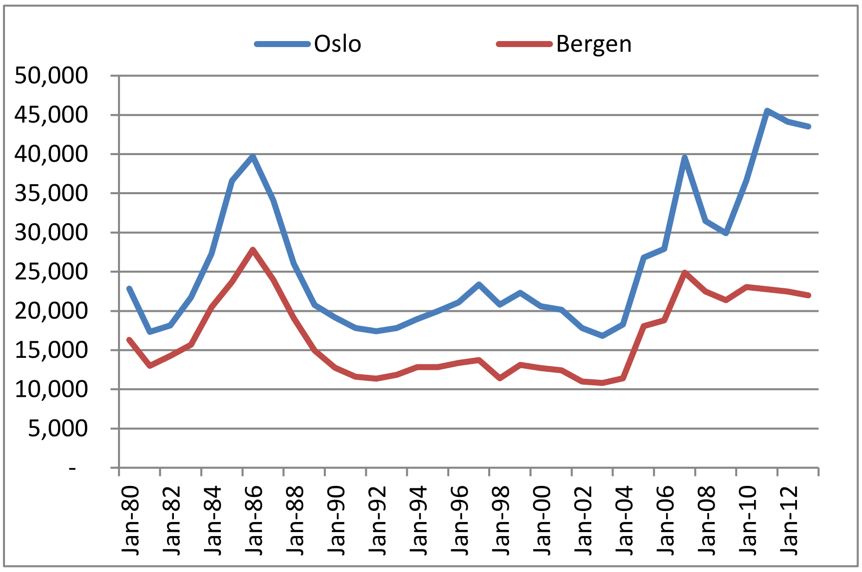


Figure 3: Real price of office premises in 1998 NOK. Oslo and Bergen



- *Which of the data mentioned in Article 101 CRR did you use?*

The data mentioned in Article 101 CRR are not available yet. Moreover, the data refer to rather recent loss experience and are of limited value when assessing appropriate standard method risk weights for commercial real estate exposures.

- Which other indicators have been taken into account?

b) Forward-looking real estate market developments

- *Motivate the forward-looking real estate market developments which justify the setting of higher risk weights or application of stricter criteria.*

Rising interest rates are likely to lower real estate prices: Low interest rates have contributed to high commercial real estate prices. Although some scholars have suggested that the "neutral rate of interest" may have fallen in recent years, interest

	rates are likely to eventually rise, with the potential to put a downward pressure on commercial real estate prices (c.f. the effect of rising interest rates in the dividend discount model). Norwegian economy is vulnerable in face of a negative oil price shock: The oil sector is currently a considerable growth factor for the Norwegian economy, and has fuelled commercial real estate markets. During the last few years the oil price has reached record levels. In the case of a persistent oil price shock, commercial real estate prices are likely to fall. Historical data suggest there is a mean reverting element to commercial real estate prices: Figure 3 in section 3.3 illustrate that commercial real estate prices in Norway have been quite cyclical and with very little drift over the last 3 decades. The price falls in the late 80s (preceding the banking crisis) and around the millennium shift bottomed out at similar levels in real terms. Currently the price level is very high (cf. figure 3).
	<u>c) Financial stability considerations</u> *Which are the financial stability considerations that were taken into account?* - Commercial real estate constitutes a large share of the banks total lending books, and real estate is also the prime collateral in lending to other business. Commercial real estate was a major driver of losses during the previous banking crisis in Norway (1988-1992). - In commercial real estate lending the propagative effects of collateral value changes are quite strong and are in effect in both booms and busts: Increasing commercial real estate prices fuel lending growth directly because commercial real estate investors often target a fixed loan to value (and at high levels of leverage). Similarly, when prices are falling the bank may require leverage to be reduced, curbing real estate financing and significantly adding to the price fall. - Introducing a lower risk for commercial real estate under the standard method may increase lending to the segment significantly. In the current situation this is problematic considering that the activity in commercial real estate is already booming, and commercial real estate prices are historically high (cf. section 3.3-a).
3.4. Frequency	*When did the Member State last change the risk weights for exposures secured by mortgages on residential property? Which change has been applied?* - For retail exposures secured by mortgages on residential property under the standardised method, risk weights have been unchanged since the implementation of 2006/48/EC and 2006/49/EC in 2006. *When did the Member State last change the risk weights for exposures secured by mortgages on commercial immovable property? Which change has been applied?* - For exposures secured by mortgages on commercial immovable property under the standardised method, risk weights have been unchanged since the implementation of Basel I in 1988.
4. Miscellaneous	
4.1. Contact person(s) at <u>consulting</u> authority	Contact person(s) for further inquiries (name, phone number and e-mail address) Name: Eivind Bernhardsen Phone number: 22939944

	Email: EIB@finanstilsynet.no
4.2. Any other relevant information	