Latvijas Banka

Regulation No. 257

Adopted 27 November 2023

**Regulations for Calculating the Capital Requirement for Credit Risk**

*Issued pursuant to*

*Section 50, Paragraph two of the Credit Institution Law and Section 4.2 of the Financial Instrument Market Law*

**1. General Provisions**

1. The Regulation establishes the procedures for applying the requirements laid down in Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012 (hereinafter – Regulation No 575/2013) to the calculations of the capital requirement for credit risk in regard to credit institutions registered in the Republic of Latvia, except for significant supervised credit institutions within the meaning of Section 1, Paragraph one, Clause 67 of the Credit Institution Law, in regard to investment firms referred to in Section 11.2 of the Credit Institution Law, investment firms referred to in Article 1(2) and Article 1(5) of Regulation (EU) 2019/2033 of the European Parliament and of the Council of 27 November 2019 on the prudential requirements of investment firms and amending Regulations (EU) No 1093/2010, (EU) No 575/2013, (EU) No 600/2014 and (EU) No 806/2014 and central securities depositories (hereinafter together – the institution).

2. The institution shall comply with the requirements of this Regulation on an individual basis and prudential consolidation group basis or on a sub-consolidated basis within the meaning of Regulation No 575/2013, ensuring that the requirements are complied with in the consolidation group or sub-group as well as in all subsidiaries included in the prudential consolidation group.

**2. Application of the Definition of Default**

3. The institution using a standardised approach to calculating its risk-weighted exposure amounts in accordance with Chapter 2 of Title II of Part Three of Regulation No 575/2013 (hereinafter – the SA approach) shall apply the requirements of Paragraphs 5–51, 53, and 55–74 of this Regulation to determine whether an obligor has defaulted in accordance with the reference to Article 178 of Regulation No 575/2013 in Article 127 of Regulation No 573/2013.

4. The institution that has been granted permission to calculate its risk-weighted exposure amounts using the Internal Ratings Based Approach in accordance with Chapter 3 of Title II of Part Three of Regulation No 575/2013 (hereinafter – the IRB approach) shall apply the requirements of Paragraphs 5–52 and 54–74 of this Regulation to the exposures on which the IRB approach has been used based on the permission to use the IRB approach, in order to determine whether an obligor has defaulted. The institution that has been granted permission to use the SA approach permanently in accordance with Article 150 of Regulation No 575/2013 or permission to implement the IRB approach sequentially in accordance with Article 148 of Regulation No 575/2013 shall apply the requirements of Paragraphs 5–74 of this Regulation based on the conditions of the permission to use the IRB approach or of the roll-out plan.

5. When applying the definition of default at the obligor level and identifying default, all exposures in the institution and in the prudential consolidation group shall be recognised as defaulted.

**2.1. Past Due Criterion for Default Identification**

6. The institution shall assess the materiality of credit obligations past due based on a materiality threshold comprising an absolute component and a relative component. The absolute component shall be the maximum amount for the sum of credit obligations past due within the meaning of Article 1(2) of Commission Delegated Regulation (EU) 2018/171 of 19 October 2017 on supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for the materiality threshold for credit obligations past due (hereinafter – Regulation No 2018/171). The relative component shall be a percentage reflecting the amount of the credit obligations past due in relation to the total amount of all on balance sheet exposures calculated in accordance with Article 1(2) of Regulation No 2018/171.

7. To assess the materiality of a delay in payments on credit obligations, the institution shall use the information at its disposal about all credit obligations owed by the obligor to the institution, the parent undertaking of that institution or any of its subsidiaries, and the following materiality threshold shall be applied:

7.1. the absolute component shall be EUR 100 for the exposures meeting the requirements of Article 123 of Regulation No 575/2013 (hereinafter – the retail exposure) and EUR 500 for other exposures;

7.2. the relative component shall be one per cent.

8. The criterion of the materiality of a credit obligation past due has been met and a default shall be deemed to have occurred when both of the materiality threshold components are exceeded for more than 90 consecutive days, except in situations when:

8.1. the respective exposure has been classified as the retail exposure and the institution has applied the definition of default at the level of an individual credit facility;

8.2. a technical default has occurred in accordance with Paragraph 16 of this Regulation.

9. The institution may recognise defaults on the basis of a lower materiality threshold if it can demonstrate that this approach of the institution reflects the obligor’s unlikeliness to pay more accurately and does not lead to the institution recognising an excessive number of defaults that return to non-defaulted status shortly after being regarded as having defaulted. The institution shall consider this trigger of default which is based on a lower materiality threshold than that which is set in Paragraph 7 of this Regulation as an additional indication of unlikeliness to pay.

10. The institution using the option of applying the definition of default to retail exposures at the level of an individual credit facility in accordance with Article 178(1) of Regulation No 575/2013 shall apply the materiality threshold at the level of each individual credit facility granted to the obligor by the institution, the parent undertaking or any of its subsidiaries.

11. The institution shall apply the EUR 100 threshold as the absolute component to the obligor’s credit obligations past due if the institution, the parent undertaking of that institution or any of its subsidiaries has an exposure to the specific obligor that has been classified as the retail exposure and an exposure other than retail exposure, and the institution is applying the definition of default to the respective exposure to the specific obligor at the obligor level.

12. If the institution has introduced changes in the payment schedule in cases provided in point (e) of Article 178(2) of Regulation No 575/2013, days past due shall be counted based on the adjusted payment schedule.

13. Where the credit facility provides the obligor with an option to temporarily suspend or postpone payments, or adjust the payment schedule and the obligor has exercised that option, these payments shall not be considered past due. The counting of the days past due shall be based on the adjusted payment schedule as soon as it is specified. Days past due shall not be counted either in situations when the payment has been suspended by force of law. In this case, the institution shall analyse the reasons for the obligor’s actions and assess the obligor for any indications of unlikeliness to pay the credit obligations.

14. Where there is a dispute between the obligor and the institution about the existence or execution of an existing credit obligation, the counting of the days past due may be postponed until the dispute is resolved, provided that one of the following conditions is met:

14.1. the dispute over the existence or size of the debt has been taken to a court or court of arbitration that will adopt a legally binding ruling;

14.2. in the case of a leasing agreement, a written complaint about the leased item has been submitted to the institution and the merit of the complaint has been confirmed by the internal audit of the institution, another independent structural unit of the institution or an external expert who has no connection with the respective transaction and is duly competent to make such an assessment.

15. A change in the obligor’s business name, given name, surname or personal identity number or other personal identifier shall not affect the counting of days past due. Where the obligor changes due to a merger or acquisition of the obligor or another similar transaction, the counting of days past due shall start from the moment a different legal or natural person takes over the obligation to pay the credit obligation.

16. The institution may consider that a technical default has occurred only in the following cases:

16.1. the institution has detected that the identification of default results from a data or system error of the institution, including manual errors in standardised processes but excluding wrong credit decisions;

16.2. the institution has detected that the identification of default results from failure of the payment system and there is evidence to the fact;

16.3. there is a time lag between the moment when the institution has received the payment made by the obligor and the moment when this payment was credited to the account from which payments of the credit obligations are made and, as a result, the obligor has made the payment before 90 days past due, but it has been credited to the account after 90 days past due;

16.4. in the case of a factoring agreement where the purchased receivables are recorded on the balance sheet of the institution and the materiality threshold has been breached but none of the receivables to the obligor is past due more than 30 days.

17. When the institution detects a technical default, it shall eliminate all errors that caused it as soon as possible. The institution that has been granted permission to use the IRB approach shall exclude data on such cases from the data set characterising defaulted exposures and used in the calibration of the model’s risk parameters.

**2.2. Specific Provisions Applicable to Exposures to Central Governments, Local Authorities, and Public Sector Entities**

18. The institution may consider an exposure to central government, local authority or public sector entity not defaulted, provided that the following conditions are met:

18.1. the contract is related to the supply of goods or services and the laws and regulations require certain controls related to the execution of the contract before the payment can be made. This condition is applicable to factoring agreements or similar types of agreements but does not apply to financial instruments such as bonds;

18.2. apart from the delay in payment, there are no other indications that the obliger might not pay the credit obligations in full. The financial situation of the obligor is sound and there are no reasonable concerns that the credit obligations might not be paid in full, including any overdue interest and penalties provided for in the contract;

18.3. credit obligations are not materially past due longer than 180 days.

19. The institution shall clearly document the use of the treatment referred to in Paragraph 18 of this Regulation and shall exclude these exposures from the calculation of the materiality threshold for other credit obligations of this obligor.

**2.3. Specific Provisions Applicable to Factoring and Purchased Receivables**

20. When applying the definition of obligor’s default to factoring agreements and the purchased receivables, the institution shall comply with the provisions of Paragraphs 27–32 of the European Banking Authority Guidelines EBA/GL/2016/07 of 28 September 2017, Guidelines on the application of the definition of default under Article 178 of Regulation (EU) No 575/2013 (hereinafter also – Guidelines EBA/GL/2016/07).

**2.4. Indications of Unlikeliness to Pay**

**2.4.1. Credit Obligations on Non-accrued Status (Point (a) of Article 178(3) of Regulation No 575/2013)**

21. The institution shall consider that an obligor is unlikely to pay where interest related to credit obligations is no longer recognised in the profit or loss statement of the institution due to the decrease in the credit quality of the credit obligations.

**2.4.2. Specific Credit Risk Adjustments (Point (b) of Article 178(3) of Regulation No 575/2013)**

22. Where an exposure is classified as credit-impaired within the meaning of the International Financial Reporting Standard 9 “Financial Instruments”, implemented by Commission Regulation (EC) No 1126/2008 of 3 November 2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council, the institution shall recognise that a specific credit risk adjustment has been made and such exposure shall be considered defaulted, except where the financial asset has been considered credit-impaired due to the delay in payment and at least one of the following conditions is met:

22.1. credit obligations are not materially past due in accordance with point (d) of Article 178(2) of Regulation No 575/2013 and Paragraphs 5–20 of this Regulation;

22.2. the exposure has been recognised as a technical past due situation in accordance with Paragraph 16 of this Regulation;

22.3. specific provisions are applied to the exposure in accordance with Paragraph 18 of this Regulation.

**2.4.3. Sale of the Obligor’s Credit Obligations (Point (c) of Article 178(3) of Regulation No 575/2013)**

23. When assessing the losses related to the sale of credit obligations, the institution shall take into account both the reasons why the losses were incurred and their materiality. The institution shall consider transactions of traditional securitisation with significant risk transfer and any intragroup sales of the obligor’s credit obligations as sale of the obligor’s credit obligations.

24. The institution shall analyse the reasons for the sale of the obligor’s credit obligations in detail to find out why the obligor’s credit obligations are being sold and the reasons for any losses recognised thereby. The institution may consider the losses (even material ones) on the sale of credit obligations as not related to credit risk and not related to the particular credit obligations of the obligor where the institution has an appropriate and documented justification, as well as where the asset subject to the sale is traded on the stock exchange and measured at fair value.

25. Where the losses on the sale of the obligor’s credit obligations are related to the credit quality of the respective credit obligations, in particular where the obligor’s credit obligations are sold due to the decrease in their credit quality and the losses are material, this shall be considered an indication of unlikeliness to pay.

26. When assessing the materiality of the losses, the institution shall compare the losses related to credit risk against the materiality threshold set by the institution which shall not exceed 5 %, using the following formula:

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where:

L is the losses related to the sale of the obligor’s credit obligations, expressed as a percentage;

E is the total outstanding amount of the credit obligations subject to the sale, including interest and fees;

P is the price agreed for the sold credit obligations.

27. The institution shall recognise the respective obligor’s credit obligations as defaulted if the losses calculated in accordance with Paragraph 26 of this Regulation exceed the materiality threshold set by the institution.

28. Losses shall be assessed for both the obligor’s credit obligations sold prior to recognising the obligor’s default as well as those that will be sold following the recognition of the obligor’s default.

29. If the sale of an obligor’s credit obligation at a material credit-risk-related loss occurred before the identification of the obligor’s default on that exposure, the institution shall consider the moment of sale as the moment of the obligor’s default.

30. In the case of a partial sale of the total obligations of an obligor where the sale is associated with material credit-risk-related losses, the institution shall treat all the remaining exposures to this obligor as defaulted, unless the institution applies the default definition at credit facility level with regard to those exposures.

31. Where an obligor’s credit obligations are sold together as a portfolio, the status of individual obligor’s credit obligations shall be determined in accordance with the manner the selling price for the portfolio of credit obligations was set. Where the selling price was determined for the total portfolio of credit obligations, the materiality of credit-risk-related losses may be assessed at the level of the portfolio of credit obligations. If the materiality threshold is breached, the institution shall consider that all obligor’s credit obligations within this portfolio of credit obligations are defaulted at the moment of the sale. Where the selling price was determined by specifying the discount on particular obligors’ credit obligations, the materiality of credit-risk-related losses shall be assessed individually for obligor’s credit obligations.

32. The institution that has been granted permission to use the IRB approach shall document and store information about the losses for the purpose of the estimation of risk parameters if the selling of the obligor’s credit obligations has resulted in material credit-risk-related losses.

**2.4.4. Forbearance or Distressed Restructuring (Point (d) of Article 178(3) of Regulation No 575/2013)**

33. The institution shall classify all non-performing forborne exposures as defaulted exposures and shall consider that forbearance measures have resulted in diminished financial obligations of the obligor.

34. The institution shall carry out an additional assessment of whether the financial obligation of the obligor has diminished as a result of forbearance measures with regard to all performing forborne exposures.

35. When assessing a forborne exposure, the institution shall recognise an obligor as defaulted in accordance with the provisions of point (d) of Article 178(3) of Regulation No 575/2013 if forbearance measures have resulted in diminished financial obligations of the obligor.

36. To carry out the additional assessment of performing forborne exposures referred to in Paragraph 34 of this Regulation, the institution shall set a threshold for the diminished financial obligations of the obligor which may not exceed 1 % and shall be calculated as follows:

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| --- | --- | --- |
| DO = | NPV0 – NPV1 | , |
| NPV0 |

where:

DO is the obligor’s diminished financial obligation, expressed as a percentage;

NPV0 is the net present value of cash flows (including unpaid interest and fees) discounted using the original effective interest rate of the loan. The net present value shall be determined based on the effective contract provisions prior to forbearance measures;

NPV1 is the net present value of the cash flows expected based on the new arrangement discounted using the original effective interest rate of the loan.

37. The institution shall calculate the diminished financial obligation of the obligor for each performing forborne exposure and compare it with the threshold set by the institution. Where the diminished financial obligation of the obligor is higher than the threshold set by the institution, the institution shall consider that forbearance measures have resulted in diminished financial obligations of the obligor and exposures have defaulted.

38. If the diminished financial obligation of the obligor is below the threshold specified by the institution, the institution shall assess such exposures for other possible indications of unlikeliness to pay that the institution has set in accordance with Paragraph 44 of this Regulation. These indications are as follows:

38.1. a large lumpsum payment is envisaged at the end of the repayment schedule;

38.2. irregular repayment schedule where significantly lower payments are envisaged at the beginning of the repayment schedule;

38.3. significant grace period at the beginning of the repayment schedule;

38.4. the exposures to the obligor have been subject to forbearance more than once.

39. The institution shall consider the obligor defaulted and that forbearance measures have resulted in diminished financial obligations of the obligor where the institution has reasonable doubts with regard to the likeliness of repayment in full of the obligation according to the new arrangement in a timely manner based on the indications referred to in Paragraph 38 of this Regulation.

40. The institution shall consider that forbearance measures have been taken and they have resulted in diminished financial obligations of the obligor if any concession has been extended to an obligor already in default.

41. Where the institution introduces any modifications of the schedule of credit obligations referred to in point (e) of Article 178(2) of Regulation No 575/2013 as a result of financial difficulties of an obligor, the institution shall assess whether the forbearance measures have resulted in diminished financial obligations of the obligor and whether indications of unlikeliness to pay have occurred.

**2.4.5. Insolvency (Points (e) and (f) of Article 178(3) of Regulation No 575/2013)**

42. The institution shall clearly specify in its internal policies what is treated as an application to recognise the obligor’s insolvency or as a legal protection mechanism similar to insolvency, taking into account all existing regulatory requirements as well as the following typical characteristics of such legal protection mechanism:

42.1. the legal protection mechanism applies to all creditors or creditors with unsecured claims;

42.2. the terms and conditions of the legal protection mechanism are approved by the court or other relevant public authority;

42.3. the terms and conditions of the legal protection mechanism include a temporary suspension of payments or partial redemption of debt;

42.4. the legal protection mechanism involves some sort of control over the management of the legal person and its assets;

42.5. if the legal protection mechanism fails to provide the expected result, the legal person is likely to be liquidated.

43. All arrangements listed in Annex A to Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings shall be treated as an application for legal protection proceedings similar to insolvency.

**2.4.6. Additional Indications of Unlikeliness to Pay**

44. The institution shall specify in its internal regulatory documents additional indications of unlikeliness to pay of an obligor, besides those specified in Article 178(3) of Regulation No 575/2013.

45. When specifying additional indications of unlikeliness to pay, the institution shall comply with the following principles:

45.1. the additional indications shall be specified per type of exposures, as defined in point (2) of Article 142(1) of Regulation No 575/2013, reflecting their specificities;

45.2. the additional indications shall be specified for all business lines of the institution, legal persons or geographical locations where it is operating;

45.3. the additional indications shall be based on both external and internal information available to the institution;

45.4. the internal regulatory documents shall outline the actions to be taken when detecting an additional indication. The institution shall clearly define the occurrence of which additional indications of unlikeliness to pay will result in an automatic recognition of defaulted exposures or trigger an additional assessment.

46. The institution may use the following internal information as an additional indication of unlikeliness to pay:

46.1. an obligor’s sources of recurring income are no longer available or they are insufficient to meet the payments of instalments;

46.2. there are justified concerns about a borrower’s future ability to generate stable and sufficient cash flows;

46.3. the obligor’s overall leverage level has significantly increased or there are justified expectations of such changes to leverage;

46.4. the obligor has breached the conditions of a contract;

46.5. the institution has called any collateral including a guarantee;

46.6. for the exposures to natural persons: default of a legal person fully owned by a single natural person where this natural person provided the institution with a personal guarantee for the credit obligations of the legal person;

46.7. for retail exposures where the default definition is applied at the level of an individual credit facility: the fact that a significant part of the total credit obligations of the obligor is recognised as defaulted;

46.8. an exposure is considered non-performing in accordance with the requirements of Annex V of Commission Implementing Regulation (EU) 2021/451 of 17 December 2020 laying down implementing technical standards for the application of Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to supervisory reporting of institutions and repealing Implementing Regulation (EU) No 680/2014.

47. When defining additional indications of unlikeliness to pay, the institution may take into account the following external information: external databases, including those of the Credit Register and credit information bureaus, macroeconomic indicators, information published in mass media, financial analyst’s reports, and other public information.

48. The institution may use the following external information as an additional indication of unlikeliness to pay:

48.1. significant delays in the obligor’s payments to other creditors have been recorded in an external database;

48.2. there is a crisis of the sector in which the obligor operates and the obligor does not have a strong position in this sector;

48.3. disappearance of an active market for a financial asset because of the financial difficulties of the obligor;

48.4. the institution has information that a third party, in particular another institution, has filed for the obligor’s insolvency or for application of a similar legal protection mechanism.

49. When specifying the additional indications of unlikeliness to pay, the institution shall take into consideration the relations within the groups of connected clients. The institution shall clearly specify in its internal regulatory documents when the default of one obligor within the group of connected clients has a contagious effect on the likeliness to pay of other obligors within this group. In situations where an obligor that is part of a group of connected clients has defaulted and the standardised treatment set out in internal regulatory documents cannot be applied to assess the impact, the institution shall assess the indications of unlikeliness to pay of all obligors within this group of connected clients on a case-by-case basis. The institution that has been granted permission to use the IRB approach shall develop its internal policies in accordance with the requirements of point (d) of Article 172(1) of Regulation No 575/2013.

50. Where a financial asset was purchased or originated by the institution at a material discount, the institution shall assess whether that discount reflects the deteriorated credit quality of the obligor and whether there are any indications of unlikeliness to pay. The assessment of unlikeliness to pay shall refer to the total amount owed by the obligor regardless of the price that the institution has paid for the asset. The assessment may be based on the due diligence performed before the purchase of the asset or on the analysis performed for the accounting purposes in order to determine whether the asset is credit-impaired.

51. If credit fraud is identified, this shall be treated as an additional indication of unlikeliness to pay.

**2.5. Application of the Definition of Default when Using External Data**

52. The institution that has been granted permission to use the IRB approach and uses external data for the purpose of estimation of risk parameters in accordance with Article 178(4) of Regulation No 575/2013 shall comply with the requirements of Paragraphs 66–70 of Guidelines EBA/GL/2016/07.

**2.6. Application of the Definition of Default for Retail Exposures**

**2.6.1. Level of Application of the Definition of Default**

53. The institution using the SA approach may apply the definition of default at the level of an individual credit facility in accordance with the second subparagraph of Article 178(1) of Regulation No 575/2013 in the case of exposures meeting the criteria defined in Article 123 of Regulation No 575/2013 even if some of those exposures, for example mortgage loans, are assigned to different exposure classes for the purpose of assignment of risk weight.

54. The institution that has been granted permission to use the IRB approach may apply the definition of default at the level of an individual credit facility in accordance with the second subparagraph of Article 178(1) of Regulation No 575/2013 in the case of retail exposures as defined in Article 147(5) of Regulation No 575/2013, ensuring that the risk parameters accurately reflect the definition of default applicable to each exposure.

55. The level of application of the default definition shall be based on the internal risk management practices of the institution. The institution may apply the definition of default for retail exposures at the obligor level even though for other such exposures the definition is applied at the individual credit facility level, if the institution can justify this approach by internal risk management practices, for example, a different business model in a subsidiary.

56. The institution which takes into account the provisions of Paragraph 55 of this Regulation and decides to apply the definition of default at both the obligor and the credit facility level shall ensure that:

56.1. the number of cases where the same obligor is subject to different definitions of default at different levels of application is limited;

56.2. different levels of application of the definition of default are clearly specified and consistently applied.

**2.6.2. Application of the Definition of Default for Retail Exposures at the Level of an Individual Credit Facility**

57. Where the institution decides to apply the definition of default at the level of an individual credit facility, it shall ensure that:

57.1. where an exposure for which the definition of default is used at the obligor level fulfils at least one of the conditions set out in Article 178(1) of Regulation No 575/2013, all exposures of this obligor are considered as defaulted, including exposures for which the definition of default is applied at the level of an individual credit facility;

57.2. where an exposure for which the definition of default is used at the level of an individual credit facility has been identified as defaulted because it fulfils at least one of the conditions set out in Article 178(1) of Regulation No 575/2013, all other exposures of this obligor are not automatically considered as defaulted;

57.3. when identifying default in the case referred to in Sub-paragraph 57.2 of this Regulation and based on the indications set out in points (e) and (f) of Article 178(3) of Regulation No 575/2013, all exposures to this obligor are considered defaulted;

57.4. the institution shall assess whether the following is applicable to other exposures of the obligor referred to in Sub-paragraph 57.2 of this Regulation:

57.4.1. any indications of unlikeliness to pay set out in points (a) to (d) of Article 178(3) of Regulation No 575/2013, paying particular attention to the indications directly attributable to the obligor’s overall situation rather than the particular exposure;

57.4.2. any of the additional indications of unlikeliness to pay which are considered to be indications reflecting the obligor’s overall situation according to the institution’s internal procedures, and, where the presence of such indication is detected, all exposures to that obligor are considered defaulted regardless of the level of application of the definition of default;

57.5. where a significant part of the total exposure to an obligor is in default, the institution shall assess whether the obligor will be able to pay other obligations in full without recourse to actions such as realising security, and whether those exposures should also be considered defaulted.

**2.6.3. Application of the Definition of Default for Retail Exposures at the Obligor Level**

58. The institution shall ensure that, when applying the definition of default for retail exposures at the obligor level, where at least one exposure to the obligor has at least one of the indications referred to in Article 178(1) of Regulation No 575/2013, all exposures to that obligor are considered defaulted.

59. A joint credit obligation shall be an exposure to two or more obligors that are equally responsible for the repayment of the credit obligation, and such obligors shall form a set of obligors. A credit obligation of an individual obligor secured by another individual or entity in the form of a guarantee or other credit protection shall not be considered a joint credit obligation.

60. When applying the definition of default for a retail exposure at the obligor level, the institution shall ensure that:

60.1. where at least one of the conditions of points (a) or (b) of Article 178(1) of Regulation No 575/2013 are met with regard to a joint credit obligation of two or more obligors, the institution considers all other joint credit obligations of the same set of obligors and all individual credit obligations of those obligors as defaulted, unless the institution can justify that the recognition of default on individual obligors’ credit obligations is not appropriate because at least one of the following conditions apply:

60.1.1. the delay in payment of a joint credit obligation results from a dispute between the individual obligors forming the set of obligors and it has been introduced to a court or court of arbitration that results in a binding ruling, and there is no concern about the financial situation of the individual obligors;

60.1.2. a joint credit obligation is an immaterial part of the total obligations of an individual obligor;

60.2. where a joint credit obligation has been recognised as defaulted, the institution shall assess whether the default of the joint credit obligation at hand constitutes an indication of unlikeliness to pay with regard to the other joint credit obligations of the obligors belonging to this set of obligors with other natural persons or legal persons which are not involved in the joint credit obligation that has been recognised as defaulted;

60.3. where at least one of the conditions referred to in Article 178(1) of Regulation No 575/2013 is met with regard to the credit obligation of an individual obligor, the institution shall assess whether such default should not be considered an indication of unlikeliness to pay with regard to the joint credit obligation of the set of obligors to which the individual obligor belongs;

60.4. where the credit obligations of all individual obligors belonging to one set of obligors have been recognised as defaulted, their joint credit obligation shall also be considered defaulted;

60.5. on the basis of the relevant national laws and regulations, the obligors that are legally fully liable for certain credit obligations jointly and severally with other obligors, therefore being fully liable for the entire amount of those obligations, shall be identified. Where there is joint and several liability for credit obligations, the default of one obligor shall not be considered as an indication of unlikeliness to pay for another obligor, and the institution shall assess whether the individual and joint credit obligations of such obligors should be recognised as defaulted;

60.6. in the situation referred to in Sub-paragraph 60.5 of this Regulation, where one of the joint and several obligors has a joint credit obligation with another obligor, the institution shall assess whether indications of unlikeliness to pay occur also on the joint credit obligations;

60.7. in the case of a sole proprietorship, the default of any of the private or commercial obligations shall cause all private and commercial obligations of such natural person to be considered as defaulted as well;

60.8. where the default is applied to an exposure to a legal person, it shall be assessed whether indications of unlikeliness to pay do not occur also with regard to the individual credit obligations of the owners, partners, members of the executive board, members of the supervisory board or shareholders as well as employees whose solvency is dependent of that legal person. Where a natural person is fully liable for the obligations of a legal person, default of that legal person shall result in the natural person’s credit obligations being considered defaulted as well;

60.9. a set of obligors that have a joint credit obligation towards the institution shall be treated as a different obligor from each of the individual obligors, and the materiality threshold referred to in point (d) of Article 178(2) of Regulation No 575/2013 shall be applied to all joint credit obligations of this specific set of obligors. When applying the materiality threshold, the credit obligations of individual obligors belonging to the set of obligors or the joint credit obligations of those obligors with other obligors shall not be taken into account;

60.10. where the materiality threshold for the joint credit obligation of a set of obligors calculated in accordance with Sub-paragraph 60.9 of this Regulation is breached and default is recognised, all individual credit obligations of the obligors belonging to this set of obligors shall also be considered defaulted unless when the institution can justify the application of the conditions referred to in Sub-paragraph 60.1.1 or 60.1.2 of this Regulation;

60.11. when evaluating the materiality of a delay in payment on an individual obligor’s credit obligation, any joint credit obligations of that obligor with other obligors shall not be taken into account, as well as where the materiality threshold has been breached only individual credit obligations of this obligor shall be considered as defaulted.

**2.7. Criteria for a Return to Non-defaulted Status**

61. For the purpose of concluding whether an exposure no longer meets all the default criteria defined in Article 178(1) of Regulation No 575/2013 and the exposure should no longer be classified as defaulted, the institution shall, in accordance with Article 178(5) of Regulation No 575/2013, carry out all the following:

61.1. verify that, for at least the last three months (hereinafter – the probation period) the exposure has no longer demonstrated any of the indications of unlikeliness to pay the obligations in full without recourse to realising security;

61.2. assess the behaviour of the obligor and changes in the obligor’s financial situation during the probation period;

61.3. after the probation period, assess the obligor’s solvency. Where the institution still finds that the obligor is unlikely to pay its obligations in full without recourse to realising security, the exposure shall continue to be classified as defaulted until the institution is satisfied that the improvement of the credit quality is factual and permanent;

61.4. check whether the conditions referred to in Sub-paragraphs 61.1–61.3 of this Regulation are met also with regard to new exposures to the obligor initiated after the recognition of default, in particular where the previous defaulted exposures to this obligor were sold or written off.

62. Where forbearance according to Paragraphs 33–41 of this Regulation was applied to a defaulted exposure and it resulted in diminishing the obligor’s financial obligations, by derogation to the provisions of Paragraph 61 of this Regulation, the institution may consider that the exposure no longer has to be classified as defaulted by applying Article 178(5) of Regulation No 575/2013, provided all of the following conditions are met:

62.1. at least 1 year (probation period) has passed from the latest between one of the following events:

62.1.1. the date of extending the forbearance measures;

62.1.2. the date when the exposure was classified as defaulted;

62.1.3. the date when the grace period included in the forbearance arrangements ended;

62.2. during the period referred to in Sub-paragraph 62.1 of this Regulation, a material payment has been made by the obligor in accordance with Paragraph 63 of this Regulation;

62.3. payments have been made regularly and in accordance with the payment schedule applicable after the forbearance arrangements, there are no past-due credit obligations;

62.4. no indications of unlikeliness to pay as specified in Article 178(3) of Regulation No 575/2013 or any additional indications of unlikeliness to pay specified by the institution apply to the exposure;

62.5. following an assessment, the institution does not consider it otherwise unlikely that the obligor will pay its credit obligations in full according to the schedule after the forbearance arrangements without recourse to realising security. An in-depth assessment, considering the risks that could affect the future expected cash flows, shall be carried out in situations where a large lumpsum payment or significantly larger payments are envisaged at the end of the repayment schedule applicable after the forbearance arrangements;

62.6. the conditions referred to in Sub-paragraphs 62.2–62.5 of this Regulation shall also apply to new exposures to the obligor, where the previous defaulted exposures to this obligor were sold or written off.

63. Material payment may be considered to be made within the meaning of Sub-paragraph 62.2 of this Regulation where the debtor has paid, via its regular payments in accordance with the forbearance arrangements, an amount equal to or larger than the amount that was previously past-due before forbearance or the amount that has been written-off under the forbearance measures if previously there were no past-due credit obligations.

64. Where the obligor changes due to an event such as a merger or acquisition of the obligor or any other similar transaction, the condition regarding a material payment referred to in Sub-paragraph 62.2 of this Regulation shall not apply to the exposure. The application of the condition regarding a material payment shall be unaffected by a change in the obligor’s business name, given name, surname or personal identity number.

65. When setting the probation periods referred to in Sub-paragraphs 61.1 and 62.1 of this Regulation, the institution shall take into account the monitoring of the effectiveness of the policy carried out in accordance with the requirements of Paragraph 83 of this Regulation. The institution may specify the probation period referred to in Sub-paragraph 61.1 of this Regulation as one period for all exposures or specify different lengths of probation periods for different types of exposures. The institution may specify a longer probation period for exposures that have been classified as defaulted during the last 24 months.

**3. Additional Requirements for Responsible Institutions of Consolidation Groups**

66. The requirements of Paragraphs 67–74 of this Regulation shall be binding on the institution responsible for compliance with the regulatory requirements at the level of the prudential consolidation group (hereinafter – the group) in accordance with the requirements of Article 11 of Regulation No 575/2013.

67. The institution shall ensure that the definition of default is introduced and applied across the group, including that the obligor’s default is identified consistently across the group with regard to all exposures to this obligor in all the legal persons in the group and in all countries where the institution is active, including countries where the institution is active without the status of a separate legal personality.

68. The institution may implement the requirements referred to in Paragraph 67 of this Regulation partially if the following conditions are met:

68.1. the institution is able to demonstrate that the effect of inconsistent identification of the obligor’s default across the whole group on the application of a single definition of default at the group level is immaterial, because there are no or very limited number of common clients among the relevant entities within a group and the exposure to these clients is immaterial;

68.2. application of a single definition of default would be burdensome, requiring development of a centralised database of all clients or implementation of other mechanisms or procedures to verify the status of each client at all entities within the group.

69. The institution, parent undertaking or any of its subsidiaries shall use the same definition of default for specific types of exposures as defined in point (2) of Article 142(1) of Regulation No 575/2013. The institution may use different definitions where the conditions referred to in Paragraphs 70 and 72 of this Regulation are met.

70. The institution may use different definitions of default for specific types of exposures, including for certain legal persons or for presence in geographical locations in ways other than via a separate legal person, where the institution can justify it by the application of significantly different internal risk management practices or by different regulatory requirements applying in the respective countries. The following reasons may serve as justification:

70.1. different materiality thresholds set by competent authorities in their jurisdictions in accordance with point (d) of Article 178(2) of Regulation No 575/2013;

70.2. the use of 180 days instead of 90 days past due for certain types of exposures to which the IRB approach is applied to calculate the risk-weighted exposure amounts in the respective country in accordance with point (b) of Article 178(1) of Regulation No 575/2013;

70.3. the institution has specified additional indications of unlikeliness to pay applicable to certain legal persons, geographical regions or types of exposures.

71. Where the option provided in Paragraph 70 of this Regulation to apply different definitions of default is used, the institution shall establish appropriate internal procedures relating to the application of different definitions of default and shall ensure that:

71.1. the scope of application of each definition is clearly specified;

71.2. the definition of default specified for a certain type of exposures, legal person or geographical region is applied consistently to all exposures within the scope of application of each relevant definition of default.

72. Where the institution has been granted permission to use the IRB approach, the use of different default definitions has to be adequately reflected in the estimation of risk parameters in the case of ratings systems whose scope of application encompasses exposures with different default definitions.

73. Where the exchange of client data among the parent undertaking and its subsidiaries or any subsidiary of the parent undertaking is restricted by laws and regulations governing consumer protection, institution’s secrecy or other laws and regulations resulting in inconsistencies in the identification of default of an obligor at the group level, the institution shall inform Latvijas Banka of these legal impediments. The institution which has been granted permission to use the IRB approach shall estimate the materiality of such inconsistencies and their possible impact on the estimates of risk parameters.

74. The institution which is a Republic of Latvia parent undertaking but is not a European Union parent undertaking shall ensure information exchange with its European Union parent undertaking and any of its subsidiaries to ensure that the calculation of the capital requirement for credit risk within the consolidation group complies with regulatory requirements.

**4. Identification of Items Associated with Particularly High Risk**

75. The institution using the SA approach shall assess whether an exposure should be classified as an item associated with particularly high risk in accordance with the requirements laid down in the European Banking Authority Guidelines EBA/GL/2019/01 of 17 January 2019, Guidelines on specification of types of exposures to be associated with high risk.

**5. Internal Regulatory Documents**

76. The institution shall develop internal regulatory documents for calculation of risk-weighted exposure amounts and calculation of capital requirement for credit risk and shall set the procedures for reporting any departures from the approved internal regulatory documents to the management. The institution shall develop internal regulatory documents in line with its size, nature, and complexity of operation as well as the amount and structure of credit risk exposures and shall provide for the resources required for their application.

77. The internal regulatory documents of the institution shall ensure effective implementation of the processes for calculating risk-weighted exposure amounts and capital requirement for credit risk in compliance with the regulatory requirements.

78. The institution shall develop internal regulatory documents outlining the application of the definition of default in accordance with the provisions of Paragraphs 79–84 of this Regulation.

**5.1. Requirements for Internal Regulatory Documents of the Institution**

79. The institution shall specify the following in its internal regulatory documents:

79.1. levels of application of the definition of default, including how the definition is applied when exposures to a particular obligor are classified in different credit obligation portfolios and the definition of default is applied to them at different levels;

79.2. materiality threshold for identification of default as well as the additional indications of unlikeliness to pay set by the institution in accordance with Paragraph 44 of this Regulation and their scope of application;

79.3. criteria for a return to non-defaulted status;

79.4. scope of application for the definition of default where the institution, its parent undertaking or subsidiary uses more than one definition of default.

80. The institution shall develop a procedure for effective and timely identification of default. The procedure shall include:

80.1. procedures for identifying default events, including application of the days past due criterion and identification of an indication of unlikeliness to pay;

80.2. procedures for counting the days past due in accordance with the provisions of this Regulation, including procedures for identification of a technical default;

80.3. procedures for applying the definition of default at the obligor level for retail exposures where the institution has not opted for the application of the definition of default for retail exposures at the level of an individual credit facility, including:

80.3.1. the approach to the application of the definition of default for joint credit obligations and contagion between exposures;

80.3.2. the identification of an obligor that is fully liable for certain credit obligations jointly and severally with other obligor, based on relevant legal provisions in a jurisdiction, but excluding credit obligations of an individual obligor secured by another individual or entity in the form of a guarantee or other credit protection. An example would be a married couple where, based on specific legal provisions applicable in the relevant jurisdiction, division of marital property does not apply;

80.3.3. procedures for the application of the materiality threshold, including application of the materiality threshold at the obligor level for retail exposures and procedures for the application of the materiality threshold for joint credit obligations;

80.3.4. procedures for the application of the definition of default for exposures to legal persons according to the effective legal provisions in the relevant jurisdiction, based on the institution’s analysis of the forms of legal persons in the relevant jurisdiction and the extent of liability of the owners, partners, shareholders or managers for the obligations of the legal person;

80.4. procedures the for application of the definition of default at the level of individual credit facility for retail exposures where the institution has opted for such option, specifying which indications of default trigger an additional assessment of other exposures to the particular obligor as well as which part of exposures should be considered material;

80.5. procedures for the application of the indications referred to in Article 178(3) of Regulation No 575/2013 and the additional indications of unlikeliness to pay identified by the institution:

80.5.1. clearly specifying which indications of unlikeliness to pay reflect the overall situation of an obligor;

80.5.2. specifying the sources of information and frequency of monitoring for each indication of unlikeliness to pay. The institution shall use both internal and external sources of information, including the Credit Register and other relevant databases;

80.6. procedures for the application of the criteria for a return to non-defaulted status.

81. To ensure effective and timely identification of default, the institution shall implement a process of circulating information and internal control mechanisms that:

81.1. enable it to obtain information to identify defaults in a timely manner and to channel the relevant information in the shortest possible time to the personnel that is responsible for taking decisions in order to recognise default. Where the institution applies automatic processes, such as counting of days past due, the identification of indications of default shall be performed on a daily basis. Where the institution applies manual processes, such as checking external sources and databases, analysis of watch lists, identification of SCRA or analysis of the list of forborne exposures, the institution shall ensure that information is updated with a regular frequency that guarantees the timely identification of default;

81.2. ensure regular assessment of the materiality of delays in payment for joint credit obligations;

81.3. ensure that information is updated every time when it is used in taking decisions, risk management, preparing internal or external reports as well as calculating capital requirements. Where the institution calculates days past due less often than daily, it shall ensure that the date of default is identified as the date when the material past due criterion has actually been fulfilled;

81.4. ensure that all exposures to a defaulted obligor or all relevant exposures to an obligor in case of the application of the definition of default at the individual credit facility level for retail exposures are marked as defaulted in all relevant IT systems without undue delay;

81.5. ensure that the internal and external reporting data prepared by the institution reflect the real situation where all exposures are correctly classified. If delays occur in the recording of the default, the institution shall ensure that such delays do not lead to errors or inconsistencies in risk management, the own funds requirements calculation or the use of data in risk quantification and risk reporting;

81.6. enable the institution to verify on a regular basis that all forborne non-performing exposures are classified as defaulted;

81.7. ensure that the institution analyses on a regular basis the forborne performing exposures in order to determine whether any of them fulfils the indications of unlikeliness to pay as specified in point (d) of Article 178(3) of Regulation No 575/2013 and in Paragraphs 33–41 of this Regulation;

81.8. ensure that, when identifying indications of unlikeliness to pay which reflect the overall situation of an obligor rather than that of the exposure, all exposures to the particular obligor are considered defaulted regardless of the level of application of the definition of default.

82. For the institution to conclude based on the provisions of Article 178(5) of Regulation No 575/2013 that none of the indications of default apply to an exposure any longer, the internal regulatory documents of the institution shall clearly specify the policies and criteria for the return to a non-defaulted status, including:

82.1. criteria for considering that the improvement of the financial situation of an obligor is sufficient to allow the full and timely repayment of the credit obligation;

82.2. the timeframe within which the repayment could actually be made where there is an improvement in the financial situation of an obligor in accordance with the provisions of Sub-paragraph 82.1 of this Regulation.

83. The institution shall monitor on a regular basis the effectiveness of its policies of the return to a non-defaulted status, analyse changes in obligor or exposure status as well as assess the policy impact on cure rates of defaulted credit obligations and on multiple defaults. A policy shall be considered effective if there is a limited number of obligors who default soon after returning to a non-defaulted status. In the case of extensive number of multiple defaults or a rising tendency, the institution shall revise its policies.

**5.2. Documentation Requirements**

84. The institution shall document the application of the definition of default, including all indications of default and criteria for a return to a non-defaulted status, as well as clearly specify the scope of application of each definition of default. The institution shall:

84.1. document in detail the operationalisation of all indications of default, including the processes, sources of information, and responsibilities for the identification of particular indications of default;

84.2. document in detail the operationalisation of the criteria for reclassification of a defaulted obligor to a non-defaulted status, including the processes, sources of information, and responsibilities assigned to relevant personnel;

84.3. keep a regularly updated register of all current and past versions of the default definition. This register shall include data about the default definition at least starting from the date of application of this Regulation and it shall include the following information:

84.3.1. scope of application for the definition of default where the institution, its parent undertaking or subsidiary uses more than one definition of default;

84.3.2. the structural unit approving the definition or definitions of default and date of approval for each of those definitions of default;

84.3.3. the starting date of application of each definition of default;

84.3.4. a brief description of all changes made relatively to the last version of the definition of default;

84.3.5. where the institution has been granted permission to use the IRB approach: the internal model change category assigned, the date of submission to Latvijas Banka, and, if applicable, the date of approval by Latvijas Banka;

84.4. the documentation prepared in accordance with the provisions of Sub-paragraphs 84.1 and 84.2 of this Regulation shall contain the descriptions of all automatic mechanisms and manual processes. Where qualitative indications of default or criteria for the return to non-defaulted status are applied manually, the description shall be sufficiently detailed to facilitate common understanding and consistent application by all responsible personnel;

84.5. where the institution has been granted permission to use the IRB approach, it shall establish the mechanism and procedures to ensure that the definition of default is implemented and applied in compliance with the effective laws and regulations as well as the provisions of Paragraph 114 of Guidelines EBA/GL/2016/07.

**6. Closing Provision**

85. The Financial and Capital Market Commission’s Regulation No. 144 of 1 September 2020, Regulations for Calculating the Capital Requirement for Credit Risk (*Latvijas Vēstnesis*, 2020, No. 177; 2022, No. 122), is repealed.

**Informative Reference to the European Union Legislation**

The Regulation contains legal norms arising from:

1) European Banking Authority Guidelines EBA/GL/2016/07 of 28 September 2017, Guidelines on the application of the definition of default under Article 178 of Regulation (EU) No 575/2013;

2) European Banking Authority Guidelines EBA/GL/2019/01 of 17 January 2019, Guidelines on specification of types of exposures to be associated with high risk.

Governor of Latvijas Banka M. Kazāks