Unofficial translation from Latvian

Regulation No. 120 of the Financial and Capital Market Commission

Riga, 9 July 2019

(Minutes No. 34, Clause 3 of the Meeting of the Board of the Financial and Capital Market Commission)

Regulation on Credit Risk Management

Issued in accordance with Section 34.[2] (4) and Section 55 of the Credit Institutions Law and Section 122.[1] (4) and Section 119.[1] (3) of the Law on the Financial Instruments Market

I. General provisions

1. Regulation on credit risk management (hereinafter - the Regulation) shall set out the minimum requirements for credit risk management, asset quality evaluation and provisioning.

2. The Regulation shall be binding on credit institutions and investment firms registered in the Republic of Latvia that are institutions within the meaning of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (hereinafter – Regulation No 575/2013), (both jointly hereinafter – institution).

3. The Regulation shall apply to the credit institutions under the supervision of the European Central Bank, if the European Central Bank has not issued its own requirements for credit risk management and asset quality evaluation. Correspondingly, Chapters VII, VIII and IX of the Regulation shall not be binding on the credit institutions under the supervision of the European Central Bank.

4. Application of provisions of the Regulation is recommended to credit unions, investment firms registered in the Republic of Latvia that are not institutions within the meaning of Regulation No 575/2013, as well as to investment management companies, alternative investment fund managers, private pension funds, payment institutions and electronic money institutions registered in the Republic of Latvia, where the Regulation is applicable to their activities.

5. Institutions shall comply with the requirements of the Regulation on individual basis and consolidated or sub-consolidated basis, ensuring that the credit risk management within the prudential consolidation group or subgroup and all its subsidiaries conforms to the requirements of the Regulation.

6. Definitions of the terms used in the Regulation:

6.1. credit risk - possibility of incurring a loss from the failure of the counterparty to fulfil its contractual obligations towards the institution;

6.2. loan - any contractual relationship between the institution and a counterparty that comprises obligations or contingent obligations and gives rise or might give rise to credit risk in the future;

6.3. credit obligations - obligations or contingent obligations arising from loan agreement;

6.4. provisions - impairment loss recognised in the financial statements in accordance with the accounting standards;

6.5. interest payment capitalisation - adding accumulated interest to the principal of the loan or interest repayment with a new loan issued to the borrower;

6.6. accounting standards - International Accounting Standards issued by the International Accounting Standards Board, International Financial Reporting Standards (IFRS) and the interpretations of the Standards of the International Financial Reporting Standards Interpretations Committee approved by the European Commission and published in the Official Journal of the European Union;

6.7. assets in stage 1 in accordance with accounting standards - assets with no significant increase in credit risk since initial recognition, within the meaning of IFRS 9;

6.8. assets in stage 2 in accordance with accounting standards - assets with significant increase in credit risk since initial recognition, but not impaired, within the meaning of IFRS 9;

6.9. assets in stage 3 in accordance with accounting standards - credit-impaired assets, within the meaning of IFRS 9;

6.10. forborne asset – exposure classified as a forborne exposure, within the meaning of Commission Implementing Regulation (EU) No 680/2014 of 16 April 2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013, (hereinafter – Regulation No 680/2014);

6.11. non-performing loan (hereinafter – NPL) – exposure classified as a non-performing exposure, within the meaning of Regulation No 680/2014, including defaulted exposure, in accordance with Article 178 of Regulation No 575/2013, or assets in stage 3 in accordance with accounting standards;

6.12. Commission – the Financial and Capital Market Commission;

6.13. financial institutions – credit institutors, credit unions, leasing companies, licensed lenders and, as far as possible, other institutions corresponding to the definition of "Statistical classification of economic activities NACE Rev. 2 Sector "K" - "Financial and insurance activities"";

6.14. the use of other terms shall correspond to the use of terms in the Credit Intuitions Law, Consumer Rights Protection Law, Regulation No 575/2013, Regulation No 680/2014, accounting standards, the Bank of Latvia regulation on compiling the monthly financial position report and compiling interest rate reports of monetary financial institutions and governing the operations of the Credit Register, Commission regulation on establishment of internal control framework and development of capital and liquidity adequacy assessment process, and Commission regulation on application of definition of default and determination of items associated with high risk.

7. Each institution shall develop credit risk management system appropriate to its activities, considering the overall volume of credit, types of loans, characteristics of its counterparties, the number of units involved in credit risk management and other factors having material effect on the level of credit risk in the institution. An institution shall ensure that credit risk is managed taking into account its interaction with other risks inherent to the operations of an institution. Credit risk management shall be performed on an ongoing basis throughout the entire life cycle of credit exposure.

8. Counterparty credit risk shall be also regarded as credit risk for the purposes of this Regulation.

9. Requirements of the Regulation shall be applicable to all types of transactions, which are exposed to credit risk in accordance with Regulation No 575/2013 (hereinafter also– credit risk exposures), *inter alia*, financial assets that are debt instruments including loans, as well as off-balance sheet items referred to in Annex 1 to Regulation No 575/2013. Requirements of the Regulation shall also be applicable to those derivatives, which are exposed to credit risk in accordance with Regulation No 575/2013.

10. Requirements of the Regulation shall be applicable to all activities and services of the institution that exposed to credit risk either in banking or trading book.

11. Institution's supervisory board (if set up) and executive board (hereinafter both jointly - the management) shall be responsible for efficient credit risk management, ensuring that the institution shall:

11.1. develop and approve credit risk strategy and policies, and define responsibility of the management in the area of credit risk management, ensuring credit risk management environment appropriate to the institution's activities;

11.2. ensure the use of clearly defined loan granting criteria;

11.3. establish and maintain efficient asset quality assessment system;

11.4. ensure adequate credit risk control in the institution and prudential consolidation group or sub-group;

11.5. ensure ongoing loan administration and measurement, assessment and monitoring of credit risk.

II. Credit risk strategy and internal documents for implementation of the credit risk strategy

12. Credit risk strategy shall form a part of the institution's overall risk strategy, which shall be aligned to internal capital and liquidity adequacy assessment process (ICAAP and ILAAP) and shall reflect the credit risk tolerance and the credit risk appetite, minimum lending standards, desirable loan portfolio structure, level of loan portfolio diversification, loan concentration limits and other parameters characterising the credit risk. The level of detail in credit risk strategy shall be determined according to the overall volume of loans and business model of the institution. The setting of credit risk tolerance and other credit risk parameters shall be based upon the assessment results of the institution's credit risk capacity.

13. Institution shall determine its ultimate credit risk capacity considering other risks inherent to the operations of the institution that arise from the risk strategy of the institution. Institution shall develop, document and consistently apply methodology for assessing the credit risk capacity of the institution, setting out methods or models to be used, as well as the parameters, assumptions and estimates thereof. Considering that the institution's credit risk capacity depends on the amount of capital in institution's disposal, the overall volume of credit and loan quality, as well as income and expenditure arising from the activities exposed to credit risk, the institution may use the analysis of the following indicators characteristic to the institution's activities in the methodology:

13.1. own funds requirement for credit risk (for previous years and projected), which is defined in accordance with requirements of Regulation No 575/2013;

13.2. the amount of capital requirement for credit risk (for previous years and projected), defined in accordance with the requirements of the Commission's regulation on the development of capital and liquidity adequacy assessment process;

13.3. credit risk - related income and expenditure (for previous years and projected);

13.4. overall volume of credit (for previous years and projected);

13.5. results of stress tests using various scenarios.

14. Credit risk strategy shall define at least:

14.1. types of loans an institution grants (for example, commercial loans, consumer loans, loans secured by residential mortgage, loans where there is mismatch between the borrower's income currency and loan currency, including unhedged loans), sector of economy, geographical location, tolerable concentration level, currency, maturity and profitability of various types of loans;

14.2. credit risk tolerance and a profit the institution is willing to generate, by assuming the relevant credit risk;

14.3. capital requirement for credit risk;

14.4. basic principles for classification of loans according to their quality;

14.5. desirable loan quality level and increase or reduction of the overall volume of credit;

14.6. credit risk mitigation methods.

15. When developing credit risk strategy, institution shall assess qualification and availability of the employees required for the implementation thereof, as well as the capacity of management information systems and organisational structure for the implementation of the strategy.

16. An institution shall develop internal documents in accordance with its size, nature and complexity of its activities, as well as the volume and structure of credit risk exposures, and shall ensure the resources necessary for its application.

17. It shall be the duty of the institution to ensure that its internal documents in the field of credit risk ensure the implementation of the credit risk strategy and prescribe the authorisations and rules for efficient loan granting, loan administration, execution of transactions with financial instruments with exposure to credit risk, identification, measurement, assessment of and provisioning for credit risk, loan monitoring, loan forbearance, NPL management, credit risk control and mitigation, as well as identification of credit risk-related fraud events. The requirements set out in internal documents shall be at least as prudent as the relevant regulations. An institution shall develop and document the internal documents related to the credit risk management in accordance with the requirements of Annex 1 to this Regulation.

18. An institution shall set out the procedure for reporting deviations from the approved internal documents.

19. An institution shall review the internal documents related to credit risk management on a regular basis, in order to ensure their consistency with the institution's business model, operational strategy, macroeconomic conditions and future outlook, as well as the best international practice and to minimise differences between the loss estimates and actual losses.

20. An institution shall determine the desirable loan portfolio structure (for example, by client profile, by type of loans) and accordingly shall define at least the following loan concentration limits:

20.1. limits on exposures to a single client or group of connected clients;

20.2. limits on exposures to persons related to the institution;

20.3. limits on intra-group exposures;

20.4. limits on claims against institution;

20.5. limits on exposures to clients related to a certain economic sector or geographical region;

20.6. limits on exposures secured by the same type of collateral or the financial instruments of the same issuer;

20.7. limits on loans issued in the currency other than the borrower's income currency.

21. An institution shall classify two or more clients into the group of connected clients, as well as shall develop the procedure referred to in Point 54 of this Regulation for identifying the group of connected clients in accordance with the requirements set out in Guidelines of the European Banking Authority of 23 February 2018 EBA/GL/2017/15 "Guidelines on connected clients under Article 4(1)(39) of Regulation (EU) No 575/2013" (hereinafter – Guidelines No EBA/GL/2017/15). In addition, an institution shall consider that:

21.1. The reference mentioned in Guidelines No. EBA/GL/2017/15 to Article 22 (1) and (2) of Directive No 2013/34/EU of 26 June 2013, on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC shall mean the reference to Article 61 of the Law on the Annual Financial Statements and Consolidated Financial Statements;

21.2. The reference mentioned in Guidelines No. EBA/GL/2017/15 to Article 23 of Directive No 2013/34/EU of 26 June 2013, on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC shall mean the reference to Article 64, 65, 66, 67 un 68 of the Law on the Annual Financial Statements and Consolidated Financial Statements.

22. An institution shall assess the need to set lower internal limit on exposures that subject to restrictions laid down in the legal acts.

23. The limits set on loans and other credit risk exposures and the standardised rules for loan granting approved by the institution shall be strictly observed and they may not be adjusted to the needs of a borrower. When the policies of an institution provide for a possibility to deviate from the set limits in exceptional circumstances, such deviation shall be approved by an executive board or a committee authorised for such purpose.

24. When the strategy provides for granting loans to borrowers, whose financial position and fulfilment of loan obligations depend upon economic, social or political situation of another member state or third country, an institution shall develop, approve and implement policies and procedures to identify and manage country risk and transfer risk, which is a component of country risk and is related to the borrower's capacity of having available foreign currency in order to meet obligations towards the institution. Restrictions on utilization of income gained in foreign

currencies effective in a relevant country shall be considered in terms and conditions of such policies and procedures.

25. Conditions for granting loans to persons related to the institution and conditions for review of agreements may not be more favourable than the conditions for loans granted or reviewed to the persons not related to the institution under similar circumstances.

26. Before implementation of a new financial service or entry into new market the institution shall analyse potential amount of credit risk associated with such services and the effect thereof on the capital requirement for credit risk. Institution shall assess the need for the development of new credit risk management policies and procedures with regard to such financial services or amending the already applicable policies or procedures. The said requirements shall apply not only to new financial services, but also to such existing financial services, where the terms and conditions change significantly.

III. Responsibility of the management of the institution in credit risk management

27. Institution's supervisory board shall have responsibility for credit risk management, and it shall:

27.1. approve a credit risk strategy that defines the credit risk tolerance and operational targets an institution plans to achieve through activities exposed to credit risk;

27.2. approve the most important policies for implementation of credit risk strategy;

27.3. monitor and control how the executive board of the institution manages the credit risk inherent to the operations of an intuition and whether such operations comply with the credit risk strategies and policies;

27.4. establish that the internal audit function shall regularly examine and assess the compliance of the institution's operations with its credit risk strategy, policies and procedures, and shall report the results of assessment to the supervisory board;

27.5. establish information exchange procedures between the supervisory board and executive board, for instance, the executive board shall submit quarterly report on credit risk management to the institution's supervisory board, summarizing information on achieving objectives set in the credit risk strategy, report the results of stress testing and, if necessary, submit an action plan for overcoming the critical situations;

27.6. ensure that the institution's remuneration policy neither contradicts to its credit risk strategy nor facilitates short-term profit making compromising medium-term and long-term objectives, when performing transactions that are exposed to credit risk;

27.7. regularly, but at least annually, review the credit risk management strategy and key policies, and assess the credit institution's own funds adequacy for covering the credit risk undertaken or to be undertaken, based on the credit institution's financial performance results and operational plans, and taking into account changes in the legal acts, economic situation, markets and forecasts, as well as the introduction of new financial services;

27.8. supervise the process of asset quality assessment and provisioning.

28. The institution's executive board shall have responsibility for implementing credit risk strategy approved by the supervisory board and credit risk management, and it shall:

28.1. ensure development of policies and procedures for credit risk management;

28.2. ensure the achievement of objectives set in the institution's credit risk strategy and implementation of policies and procedures for credit risk management;

28.3. establish the allocation of powers, duties and responsibilities for credit risk management among a credit institution's units and responsible employees;

28.4. approve the stress testing procedures, scenarios and procedures for reporting results of credit risk management stress testing, assigning a unit or employees responsible for preparing and submitting reports to the executive board, and shall control their timeliness;

28.5. ensure informing the employees engaged in the loan granting process and credit risk management about the credit risk strategy, policies and procedures and their responsibility for compliance with the policies and procedures of an institution;

28.6. ensure the recruitment of such employees, whose qualification corresponds to the duties to be performed in the field of credit risk management;

28.7. ensure ongoing compliance with loan granting criteria and maintenance of high ethical standards, when performing credit risk management;

28.8. approve loan concentration limits and shall ensure compliance thereof;

28.9. review and assess asset quality assessment results and adequacy of the provisions on a regular basis.

IV. Management information system

29. An institution shall implement a management information system that enables quantification of the amount of credit risk and ensures high-quality, detailed and timely reporting on the structure of loan portfolios to be managed, on the clients, including interconnection of the clients, as well as information that enables identification of persons related to the institution, information on compliance with the various amounts and limits of loan concentrations, as well as data on historical results from the loan recovery and application of forbearance measures (recovery costs, duration, actual profit or loss) by types of loans.

30. Management information system shall ensure timely delivery of information to the appropriate level of management of in case the concentration or any other limits are exceeded.

31. Information provided in the management information system shall enable the management of an institution to duly monitor the credit risk management system, including maintenance of capital requirement for covering credit risk and analysing the results of stress testing. Management information system shall provide for assessment of both the total amount of the institution's credit risk and the amount of credit risk of various portfolios or activities in a timely and credible manner as well as make judgement on compliance of the credit risk amount to the credit risk strategy targets.

32. The institution's management information system shall ensure that all sources of credit risk are identified, the amount of credit risk is measured and assessed and monitoring of credit risk is conducted at the level of portfolio, unit, subsidiary as well as at prudential consolidation group or sub-consolidated level.

33. An institution shall establish and document a transparent communication and reporting mechanism to ensure that the management, units and employees of an institution are able to receive and exchange information about the credit risk management, *inter alia*, changes in the

level of credit risk, and a comparison of expected loss calculation with the actual loss as well as credit risk analysis and monitoring.

34. The institution shall, as far as possible, apply the same data, assumptions and processes in measuring and managing the credit risk, *inter alia*, in the process of loan granting, as it in valuation of items on its financial statements and budgeting. Prior to using internal or external data in credit risk management, an institution shall carry out appropriate data quality checks and shall ascertain the accuracy of data and the suitability to the purpose of use.

V. Granting of loans

General requirements

35. Institution shall set and follow strict and clearly defined loan granting criteria and limits that ensure implementation of credit risk policy of the institution in accordance with the credit risk strategy and shall be applicable, when assessing the impact of the planned exposure on the credit risk of the institution and the ability to absorb it. Loan granting criteria and limits shall be set for each target market, type of loans to be issued (including unsecured loans), purpose of the loan and the repayment capacity of the borrower (hereinafter - creditworthiness), including defining loan limit vis-à-vis the value of the collateral and income of the borrower. Institution shall regularly assess compliance and efficiency of loan granting criteria.

36. Institution shall ensure that the credit risk assessment includes the evaluation of borrower's creditworthiness and credit risk mitigating factors, *inter alia*, collateral (if any). Existence of collateral shall substitute the assessment of borrower's creditworthiness and reception of required information.

36.[1] Institution shall ensure documentation of the creditworthiness assessment and decision on loan granting or refusal. Documented results shall be sufficient to justify the proposal to approve or decline the loan agreement.

37. Institution shall set the tolerable maximum loan repayment term for various types of loans, except for overdrafts, revolving loans, credit lines and payment card loans or similar products, the issuance and repayment whereof is not set out in a pre-agreed repayment schedule, and the increase and repayment is possible for the entire term of contractual relationship within the scope of a limit (hereinafter all of the above - overdrafts). The maximum repayment term of a residential mortgage loan issued to a natural person shall be 30 years, but the maximum repayment term of a consumer loan (including financial lease transactions) shall be seven years.

38. Institution shall set out procedure for taking decisions on loan granting and for loan repayment, the documents and information required for taking loan granting decision, as well as the powers and responsibility of the management board, established committees (credit committees) and employees involved in granting of loans, including loans granted via automated decision-taking processes.

39. Where the institution participates in syndicated loan granting process, it shall perform the analysis of credit risk and credit-granting terms independently from the analysis conducted by the arranging bank of the syndicated loan before taking decision on loan granting,.

40. Institution shall enter into agreement with the borrower, stating the purpose of the loan, amount, procedures for pay-out and repayment, interest rate and procedure for interest calculation, loan collateral and other conditions.

41. Prior to entering in the loan agreement, institution shall provide the borrower with complete and fair information about all contractual conditions and risks, including:

41.1. the structure (principal and interest payments) and amount of regular payments of the borrower;

41.2. for loan agreement with floating interest rate warn the borrower about the risks associated with the impact of growing interest rates on loan payments, providing examples of calculations that illustrate the potential impact of interest rate growth on the amount of debt service expense and debt service to income (DSTI) ratio;

41.3. where the loan currency does not match the borrower's income currency, warn the unhedged borrower about the risks associated with unfavourable changes in the currency rates, and the impact of such changes on the amount of payments, as compared to the situation, where the borrower's income currency matches the loan currency. Institution shall provide the borrower with examples of calculations that illustrate the potential impact of changes in the loan currency rate on the amount of the debt service expense and the debt service to income (DSTI) ratio. Where the borrower's income currency rate is pegged to the loan currency rate, the institution shall explain the currency peg conditions.

41.4. where the borrower is a financial institution, insurance company or other financial market participant, having sufficient knowledge and experience in financial risk management, institution may reduce the scope of information to be provided, if the borrower agrees.

42. When using technology-related automated solutions (hereinafter - automated solutions) for loan granting, institution shall:

42.1. provide conditions for using automated process solutions, *inter alia*, stating the products and limits, for which automated decision-taking is allowed, considering the limits of automated solutions;

42.2. duly incorporate risks pertaining to the use of automated solutions in its risk management and control systems, providing for appropriate restricting control mechanisms, for instance, early warning criteria and criteria for suspending the operation of automated solutions;

42.3. be able to explain the underlying model of the automated solutions used and shall ensure their traceability and stability;

42.4. monitor the performance results of automated solutions on regular basis and compare actual performance with the modelled performance;

42.5. duly document and review the technology-related automated processes and models from time to time.

Borrower's creditworthiness assessment

43. This Regulation shall set out the minimum requirements for assessing the creditworthiness of a borrower. Institution may set stricter requirements.

44. The income of the borrower shall be considered as the key source of loan repayment, while collateral or other risk mitigation factors shall ensure additional protection.

45. Borrower's creditworthiness assessment shall cover the analysis of at least the following information: purpose of the loan, financial condition of the borrower and its sustainability, loan

repayment sources, risk already assumed by the borrower, overall volume of risks and vulnerability to changes in economy, borrower's financial contribution in funding the purpose of the loan, loan collateral.

46. Institution shall develop internal procedure on the volume and level of detail of information to be used in assessing the creditworthiness of the borrower, considering the volume and type of the loan to be issued. Where the borrower is a consumer within the meaning of the Consumer Rights Protection Law, an institution shall also consider the requirements laid down in the Consumer Rights Protection Law. Information to be used in assessing the creditworthiness of the borrower shall contain data on the income of the borrower, their obligations and related payments, and it shall form the basis for further decisions on loan granting.

$46.^{1}$ Information referred to in Point 46 of this Regulation for assessing the borrower's creditworthiness shall be obtained from the borrower and institution's internal and external (Credit Register, credit information agencies, State Revenue Service, State Social Insurance Agency and other data bases) sources.

$46.^{2}$ Institution shall request the borrower to confirm the accuracy and completeness of information provided in the loan application.

$46.^{3}$ Institution shall check, as far as possible, the accuracy and completeness of information provided by the borrower.

$46.^{4}$ Information about the income of the borrower, who is a consumer, shall be considered sufficient, if it meets the requirements of the Consumer Rights Protection Law and this Regulation.

$46.^{5}$ Information about the obligations of the borrower and related payments shall be considered sufficient, if its provides an appropriate picture about the amount of monthly payments made by the borrower, considering the information available from the credit information agencies and the Credit Register, as well as information provided by the borrower. If the amount of obligations or monthly loan payments specified by the borrower exceeds the amount set by the institution considering the available information in external and internal databases, when assessing the creditworthiness of the borrower, the institution shall use the information provided by the borrower.

47. When assessing the creditworthiness of a borrower, who is a consumer, institution shall use the following minimum ratios:

47.1. debt service to income ratio (hereinafter - DSTI), calculated as follows:

$$DSTI = \frac{DS}{I},$$

where:

DS is the total amount of credit payments to financial institutions per month both for the loan the borrower has applied for and for other loans of the borrower, including loans granted and not yet used, *inter alia*, overdrafts, but without credit payments for debt obligations that would be settled as a result of granting of the planned loan.

The total amount of credit payments to financial institutions shall be comprised of the repayment of the principal amount, interest payments, commissions and other regular payments

to be settled under lending agreements. The total credit payments to financial institutions per month shall be obtained by adding up credit payments of all loans. Institution shall use all information at its disposal, obtained from the sources referred to in Point 46[1] of this Regulation for calculating the credit payments. Institution may increase the amount of the credit payments to be assessed, as compared to the amount of the credit payments according to information provided by the borrower, if the institution considers it, based on the internal procedure of the institution for the borrower's creditworthiness assessment, to be justified.

Institution shall set in its internal procedure sufficiently conservative assumptions regarding the interest rates of loans issued by other financial institutions. Institution shall analyse the borrower's creditworthiness, considering the possibility that floating loan interest rates may change considerably in the trend that is not favourable to the borrower. If there is a mismatch between the loan currency and borrower’s income currency, institution shall consider the potential currency rate change in the trend that is not favourable to the borrower.

If the frequency of credit payments is less than once per month (quarterly, semi-annually, annually, or other), the amount of credit payments per month shall be estimated as an average monthly ratio for the relevant frequency (for example, dividing the quarterly payment by 3).

Where the loan repayment is deferred or made at the end of the term (bullet loan), the amount of credit payments per month shall be estimated as an average monthly ratio, assuming that the remaining (outstanding) obligations of the borrower (including principal amount and interest) shall be repaid in equal parts up to the expiry of the ultimate term of obligations.

The amount of monthly overdraft payments per shall be assessed, by dividing the amount of the granted credit limit by 48 (assuming that the term of such loan is four years).

Interest rates of overdrafts issued by companies that have a licence for providing consumer lending services, shall be considered as the maximum amount of total costs of loan as set out in the Consumer Rights Protection Law, but the interest rates of overdrafts issued by other lenders shall be assumed at least in the amount of payment card credit interest rates newly issued to the households by monetary financial institutions of Latvia, as posted on the website of the Bank of Latvia.

For loans that granted in portions within the scope of the granted credit limit and where the pay-out and repayment is defined in a pre-agreed repayment schedule (for example, construction loans), the amount of monthly credit payments shall be assessed as a monthly average ratio, based on the granted total credit limit and assuming that the obligations of the borrower (including the principal and interest) are repaid in equal parts by the expiry of the term;

I is average monthly income of the borrower after the taxes payments and other mandatory social contributions to be paid to the State that are documented and can be verified and recognised as sustainable by the institution (for example, considering the expected retirement age, temporary employment contract, etc.), based on data for at least last six months, for which

there is available information on borrower's income. If income for the last six months does not illustrate the regular income of the borrower, then a longer time period shall be used, with appropriate justification;

47.2. annual debt to income ratio (hereinafter - DTI), calculated as follows:

$$DTI = \frac{D}{I},$$

where:

D are all debt obligations of the borrower towards all financial institutions and, as far as possible, also non-financial institutions, including the loan which the borrower has applied for, and the granted but not yet used loans, but without debt obligations that would be settled as a result of granting the planned loan;

I shall be obtained, by multiplying the average monthly income calculated in accordance with Point 47.1 of this Regulation by 12;

47.3. loan to value ratio (hereinafter – LTV), calculated as follows:

$$LTV = \frac{L}{V},$$

where:

L is the amount of the planned loan;

V is the collateral value;

47.4. should the DSTI referred to in Point 47.1 of this Regulation exceed 40 per cent or the DTI referred to in Point 47.2 of this Regulation exceed the coefficient 6, the creditworthiness of the borrower shall be assessed as insufficient, and the granting of such loan is not permitted, except where the borrower's creditworthiness assessment demonstrates that the borrower will be able to repay the loan also with higher DSTI or DTI level. Exceptions referred to in this Point, as well as deviations from the maximum term restrictions referred to in Point 37 of this Regulation may not exceed 10 per cent of the amount of loans newly issued by an institution to natural persons per calendar quarter (based on the last available information for the previous calendar quarter). Institution shall explain the risk-mitigating elements in the specific case where exceptions are applied;

47.5. the maximum loan term requirements, DSTI and DTI requirements referred to in Points 37 and 47.4. of this Regulation shall not apply to cases, which in are Consumer Rights Protection Law are set out as exceptions where the institution is exempt from the duty to assess the ability of consumer to repay the loan, as well as to forborne assets.

48. Where a borrower still has outstanding credit obligations after the expiry of the loan term (for example, loans under recovery procedure), the institution shall be prohibited to issue a new loan to the borrower, unless done within the scope of forbearance measures in accordance with Chapter VII of this Regulation.

49. Institution shall assess the effectiveness of the loan guarantees (if any), possibilities and time of required for exercising loan guarantees, as well as the creditworthiness of third parties guaranteeing the loan to be issued.

50. Borrower's creditworthiness and the ability of the guarantor to fulfil the obligations arising from the guarantee agreement shall be assessed separately.

$50.^{1}$ When assessing the guarantor of the consumer lending agreement, who does not carry out economic activity, on his ability to fulfil the obligations arising from the guarantee agreement, institution:

$50.^{1}$1. shall apply the requirements referred to in Point 37 and Point 47.4 of this Regulation to the guarantor providing the guarantee, including in the calculation both the guarantee obligations for the agreement to be concluded and other existing outstanding guarantee obligations - both in the amount of at least 50%;

$50.^{1}$2. shall determine the amount of guarantee of each involved guarantor in the guarantee agreement;

$50.^{1}$3. where several guarantors are involved, income and credit payments of such guarantors may be aggregated in the assessment of the DSTI and DTI.

$50.^{2}$ If loan is issued to a borrower who simultaneously is a guarantor with respect to other obligations, guarantees provided by the borrower (including guarantees for legal entities) shall be considered in the calculation of their DSTI un DTI in the amount of at least 50 per cent of the outstanding obligations as a guarantor.

$50.^{3}$ Institution shall develop criteria for setting the proportion of outstanding obligations of the guarantor referred to in Points $50.^{1.}$1 and $50.^{2}$ of this Regulation higher than 50 per cent.

$50.^{4}$ Where the loan agreement foresees joint responsibility of several borrowers for loan repayment, the income and credit payments of the borrowers may be aggregated in the assessment of DSTI and DTI. If the loan agreement foresees different level of liabilities among borrowers, institution shall develop a procedure for including the different liabilities of the borrowers in the DSTI and DTI calculation.

$50.^{5}$ Where a joint borrower, who has already undertaken joint debt obligations, is willing to take a new loan, institution may:

$50.^{5}$1. repeatedly assess the creditworthiness of all joint borrowers in total, based on current data on their income, credit payments and guarantees;

$50.^{5}$2. assess the individual creditworthiness of the borrower, based on current data on their income, credit payments and guarantees, assuming that the existing joint credit obligations and monthly payment is divided by the number of borrowers (for example, where there is a principal borrower and one joint borrower, credit obligations shall be divided by two), unless other distribution of liability is foreseen in related loan agreements.

$50.^{6}$ Institution shall analyse the income stability of borrower, who is a consumer, including assessment of the development of economic sector or geographic region of the borrower's source of income. Institution shall set stricter requirements for granting loans to borrowers with

higher credit risk, including application of stricter DTI, DSTI or LTV limits to borrowers with fluctuating or irregular income or whose income currency mismatches the loan currency.

50.[7] Institution shall analyse regular expenses of borrower, who is a consumer, that not related to the debt repayment (for example, rent, public utility payments, expenses for dependants, etc.), and shall consider them, when assessing the creditworthiness of the borrower. Institution shall develop its own methodology and calculations for determination of such expenses.

51. Institution shall set out procedures for issuing buy-to-let residential loans or other income-generating residential loans, that result from borrower's operations with real estate. Loan amount for such loans may not exceed 70 per cent of the collateral (real estate) market value for such loan, and, when assessing the creditworthiness, the forecasted income from the real estate shall be considered in the amount of not more than 70 per cent.

52. Institution shall assess to what extent the risk of borrower, who is a consumer, depends on the declared income generated by the real estate (for example, rent or other income resulting from the borrower's operations with real estate), and to what extent - upon other sources. If the declared income from real estate exceeds 20 per cent of the overall income of the borrower and, if the amount of the loan the borrower has applied for exceeds 70 per cent of the market value of the collateral (real estate) of such loan, then the creditworthiness of the borrower shall be assessed as insufficient.

53. When assessing the creditworthiness of the borrower, who performs economic activity, institution shall analyse the results of the economic activity, financial condition, expected loan repayment cash flow, development of the relevant economic sector or geographic region, as well as the borrower's management proficiency.

54. Institution shall determine and consider the affiliation of the borrower to a group of connected clients or persons affiliated to an institution in the borrower's creditworthiness assessment. To determine such affiliation, institution shall develop procedure for identification of persons affiliated to the institution and groups of connected clients.

Loan pricing

55. An institution shall define the principles and procedures for pricing loans, including all elements for loan pricing and thereby ensuring that is can justify loan pricing decision.

55.[1] Institution shall commensurate the risks associated with the loan and the expected benefits, taking into account the cost of resources, existence of collateral and other restrictive conditions, as well as whether the currency of borrower's income matches the currency of the loan, when deciding on loan agreement conditions. The price shall be determined to cover all loan-related costs and compensate for the risk assumed by the institution.

Assessment of collateral

56. Institution shall define eligible collateral for issuing different types of loans and shall set up a mechanism for evaluation of various types of collateral and monitoring of the collateral value.

56.[1] Institution shall analyse the existence, eligibility and adequacy of collateral, considering the LTV prescribed in the loan granting policy, as well as the enforcement or other options of using the collateral under different scenarios.

56.[2] Institution shall verify the legal conditions of the collateral, ensuring that the enforcement (foreclosure, sale) of collateral is possible, insurance options and other conditions before recognising the collateral as eligible.

56.[3] If the loan is secured with a deposit placed with the institution, the institution shall ensure whether there are no impediment for claims and obligations netting also in case of initiation of an insolvency procedure against a collateral issuer. If a transaction (total amount of transactions) is significant and subject to a number of jurisdictions, an institution shall provide a legal opinion on the possibility of netting claims and obligations.

VI. Loan administration and monitoring

Loan filing

57. An institution shall perform ongoing monitoring of the loans that includes loan filing, preparation and sending out notifications and other necessary documents.

58. An institution shall develop and implement a loan monitoring system to ensure:

58.1. efficient monitoring of documentation, contractual terms, restricting conditions and collateral;

58.2. accuracy and timeliness of information provided in the management information system;

58.3. compliance with the principle of segregation of duties, ensuring that the storage of originals of the most important documents, transfer of resources and input of information into data base of the institution shall be performed by different employees;

58.4. compliance with laws and regulations, as well as the approved internal documents of the institution.

59. An institution shall continually assess and document in the loan file the borrower's ability to meet contractual obligations. An institution shall ensure that the loan file contains all the information required for the assessment of the current financial condition of the borrower and for the transparency of decision-making process and credit history (for instance, regular financial reports and their analysis, documents proving the existence and the amount of the borrower's income, documents proving the use of the loan for the intended purpose in the agreement, loan assessment documentation, internal reporting to the management of the institution, correspondence with the borrower, the borrower or collateral survey reports, collateral valuation and the results of the value monitoring or reference to the document or other data storage device containing them).

Loan quality monitoring

60. An institution shall establish and implement a monitoring system for an ongoing assessment of quality of individual loans or loan portfolios.

61. Loan quality monitoring system shall ensure that:

61.1. an institution understands current and expected financial condition and creditworthiness of the borrower;

61.2. contractual conditions are complied with, including a condition that the issued loan is used for purpose defined in the agreement;

61.3. adequacy of collateral is assessed, considering changes in the market and the its development trends;

61.4. institution duly responds to the early warning system signals on deterioration of the loan quality;

61.5. institution shall take viable loan agreement forbearance measures suitable for the borrower's situation;

61.6. institution shall take measures set out in internal documents to ensure cure or recovery of loans with significant deterioration in the loan quality, for instance, additional analysis of the borrower's problems, enhanced controls over the borrower's current account, audit of loan and collateral documentation, development of a plan of remedial measures.

62. An institution shall set out in internal documents the criteria which shall drive initiation the loan recovery (collateral enforcement) measures.

63. The management of the institution shall assign employees responsible for monitoring the quality of individual loans and loan portfolios, the quality of collateral or guarantee providers. In setting the duties of the employees, the executive board of an institution shall consider the possible conflict of interest, in particular, regarding employees whose performance appraisal depends on such criteria as the overall volume of credit, quality of loans or loan portfolio or short-term profitability or result of valuation of the collateral.

64. The remuneration of employees involved in credit risk monitoring must not depend on the criteria referred to in Point 63 of this Regulation. The institution shall ensure that its remuneration policy facilitates effective loan monitoring and motivates the employees of the institution to respond to the first signs of deteriorating loan quality, to prevent further deterioration of loan quality.

65. The institution shall establish a mechanism for regular monitoring of loan collateral value and liquidity for all loans, for which an institution has accepted collateral. The institution shall update the collateral value, on a regular basis, by performing individual asset evaluation or applying value indexation or other statistical methods. Where an institution applies indexation method, it shall establish that the indices used are reviewed on a regular basis, they are applicable to the relevant type of real estate and based upon actual real estate transactions during a sufficient time period.

66. The institution shall approve a list of internal and external appraisers and shall establish that the experience and expertise of the appraisers on the list cover the markets and industries where the institution has issued collateralized loans. The institution shall challenge the quality of the valuations provided by the appraisers, involving the risk control and internal audit function in the process of selection of appraisers and assessment of the quality of valuations.

Early warning system

67. The institution shall carry out loan quality monitoring for performing loans, in order to detect the loan quality deterioration timely basis and to, initiate measures for prevention of further loan quality deterioration as soon as possible,.

68. The institution shall define a set of appropriate indicators or features for early warning regarding loan quality deterioration and inclusion of the client on the watch list of clients with early quality deterioration features (for example, more than 15 days past due payments, deterioration

of the financial condition of an enterprise, insolvency claim on the enterprise where the client works) at individual borrower and transaction level and for each significant loan group of in the institution, that contains loans with shared risk parameters. If an institution does not have (it cannot form) loan groups with shared risk parameters, it shall assess the loans only on an individual basis.

69. Institution shall apply external or internal data sources for indicators or features, updating the data contained therein on a regular basis.

70. Institution shall assess the occurrence of early quality deterioration features at least once a month both at the level of groups and separate borrowers and loans.

71. Where the institution identifies loan quality deterioration features at the level of the loan group or borrowers' group, it shall carry out a detailed verification of such group and define the measures to be taken for mitigating the risk of further loan quality deterioration for individual loans.

72. Institution shall ensure that the loans with early quality deterioration features are appropriately marked in the management information system and regularly included in the asset quality reports to the management of the institution.

Internal rating system

73. Institution may apply internal rating system for the purposes of loan quality monitoring., The internal rating granted to the borrower within the scope of the internal rating system shall reflect their creditworthiness and corresponding loan quality and shall be granted based on several criteria, for example, type of loan, type, scope and location of collateral, probability of default (PD), credit history and other characteristics of the borrower. Internal ratings may be used for defining the capital requirements for credit risk, pricing of loans, monitoring the quality of loans or loan portfolios, calculating the expected loss and adequacy of impairment provisions.

74. Institution shall review the internal rating granted to the borrower on a regular basis to ensure the consistency of the internal rating to the quality of the loan, based on the changes in indicators affecting the creditworthiness of the borrower, for example, industry development trends, growth indicators of the borrower and macroeconomic outlook. Granting or approval, as well as the review of internal rating shall be carried out by the employees who not involved in the loan granting process, engaging employees from the internal control function.

75. Internal rating system shall cover all loans, not only the loans in Stage 2 or Stage 3 in accordance with the accounting standards. Such internal rating system shall ensure a sufficiently detailed credit risk measurement and classification of loans by similar credit risk parameters, as well as shall reflect the level of credit risk for each individual loan and the loan portfolio as a whole.

Measurement, assessment and monitoring of credit risk

76. Institution shall ensure the measurement and assessment of the credit risk as part of credit risk management. Institution shall set the credit risk level for the first time at the moment of loan origination, in order to ensure measurement of credit risk over the entire expected life of the loan.

77. Institution shall consider the expected loss of the loan and the capital requirement for credit risk, namely, the capital necessary to cover unexpected loss, when measuring and assessing credit risk.

78. Institution shall set out the methodology in internal documents that enable assessment of credit risk of exposures to individual debtors, securities or securitisation positions and credit risk at the loan portfolio level. The institution shall ensure that it does not mechanically rely only upon credit ratings provided by external credit assessment institutions (rating agencies) for assessment of credit risk within the meaning of Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, as well as does not use them as the sole credit risk assessment criterion.

79. Institution shall monitor credit risk at the level of individual loans, loan portfolios (mortgage loans, credit lines, derivative financial instruments and portfolios of other loans), credit exposures or their portfolios and overall credit risk level inherent to the operations of the institution.

80. Institution shall apply analytical methods that appropriate to the nature and complexity of its activities in measurement, assessment and monitoring of credit risk. The principles and the selection of methods applied, as well as the underlying assumptions and estimates used therein shall be documented and reviewed on a regular basis. The institution may not excessively rely on a particular analytical method in assessing credit risk; a quantitative credit risk measurement must at all times be supplemented with a qualitative expert assessment.

81. Institution shall consider forbearance measures for loans whose quality has deteriorated significantly, an in accordance with the requirements of Chapter VII of this Regulation or developing a loan recovery programme prescribing, for instance, enforcement of collateral or initiation of insolvency.

Significant increase in credit risk

82. Institution shall perform the asset quality assessment on regular basis, i.e., at least quarterly and whenever the institution receives information indicating that a significant increase in credit risk has occurred or is likely to occur..

83. Institution shall assess the significance of increase in credit risk in accordance with accounting standards, focusing on the following features:

83.1. decrease in the internal or external credit rating of a counterparty or deterioration of rating forecast;

83.2. the borrower has informed the institution of the wish to change contractual conditions, that would classify as asset forbearance;

83.3. an issuer has proposed a review of prospectus;

83.4. the borrower has been included in the watch list of clients with early quality deterioration features;

83.5. an institution has decided to increase the requirements for collateral or to set stricter contractual conditions with respect to new loans granted that are similar to outstanding loans, and the rationale of the decision is increase in credit risk from the initial recognition of the already issued loans.

84. Institution shall not use 30-days-past-due indicator as the sole indicator of significant increase in credit risk, whereas all assets where the days past due exceed 30 days shall be regarded as assets in Stage 2 in accordance with accounting standards.

85. If the institution concludes that no significant increase in credit risk has occurred to the asset in Stage 1 in accordance with accounting standards, it shall, if necessary, increase the provisions without relocating the asset to Stage 2 in accordance with accounting standards.

86. If assets have not been derecognised in accordance with accounting standards when applying forbearance measures, the institution shall assess significant increase in credit risk since the initial recognition, comparing the probability of default before and after application of forbearance measures. The institution shall consider the impact of forbearance measures on the ability of the counterparty to meet its obligations, financial condition of the counterparty and future forecasts of the industry, as well as shall assess the business plan of the counterparty and its compliance with the repayment schedule after the forbearance measures.

87. Where the institution applies low credit risk exemption, that allows drop assessment of a significant increase in credit risk for an asset in accordance with accounting standards, the institution shall assess and document evidence that the asset is low credit risk status is justified. Institution shall not apply this exemption to loans, except where the counterparty is a central government and the credit rating assigned to the counterparty by external credit rating institution corresponds to the credit quality step from one to three in accordance with Article 114 of Regulation No. 575/2013 or such local government, which the competent authority of the relevant Member State treats as the central government referred to in this Article in accordance with Article 115 of Regulation No. 575/2013.

88. All assets in Stage 3 in accordance with accounting standards or assets under recovery shall classify as non-performing assets.

89. Institution shall assess and recognise significant increase in credit risk for the asset as a whole, without dividing it into components.

90. Institution shall use all information, which it has obtained or may obtain, and which is available without undue effort or excessive costs, when assessing significant increase in credit risk. An institution shall determine internal and external information sources and methods for application of information in determining and evaluating significant increase in credit risk. The institution shall rely more upon qualitative and forward-looking information, and not only on the number of past-due days within the assessment of significant increase in credit risk and assignment of the NPL status for assets that the institution assesses on an individual basis. ,

91. Institution shall use appropriate scenarios in the calculation of expected losses, applying the prudence concept. For the baseline scenario the institution shall apply, as far as possible, the same data and assumptions as those applied for preparation of financial statements and budgeting. Institution shall determine the timeline covered by the scenarios, applying detailed macroeconomic outlook over a time horizon of two to three years and afterwards following the general economic development outlook.

Internal model validation

92. Institution shall, on regular basis but at least annually, carry out validation of the models applied in the calculation of expected losses. The institution shall ensure validation of its models, upon commencement of the use, as well as after introduction of material changes.

93. Model validation shall be performed by staff who have the necessary qualification, expertise and experience and who have not been involved in the development of the model.

94. Model validation shall include at least the analysis of the model inputs, assumptions used the model and model outputs. Institution shall ensure that duties and responsibilities are clearly allocated, in order to conduct a high-quality and independent model validation, as well as obtain appropriate model validation documentation.

95. An institution shall, at least biannually, conduct back-test of the estimated losses and actual losses for all significant asset portfolios. Should significant differences be found between the estimated and actual losses, institution shall inform the internal audit function to this effect and shall adjust the loss measurement methods, to minimise such differences.

Assessment of the effectiveness of the credit quality management

96. Institution shall establish a set of indicators to be applied in measuring the effectiveness of credit quality management, which may contain the following indicators:

96.1. NPLs vs total loans;

96.2. impairment provisions for NPLs vs gross NPLs;

96.3. maximum amount of additional impairment provisions, which can be covered by calculated capital surplus exceeding the own funds requireme

96.4. maximum amount of additional impairment provisions, which can be covered by the profit for the reporting period, without reducing own funds;

96.5. breakdown of loans by rating groups in accordance with the assigned internal ratings;

96.6. internal ratings migration matrix.

VII. Forbearance

97. Institution shall grant forbearance measures with an aim to enhance credit quality, ensure sustainable loan repayment and avoid foreclosure or sale of collateral.

98. Institution shall develop the forbearance policy for loans, outlining the approach to granting forbearance measures for different loan products, types of borrowers (natural person or legal entity), substance and complexity of the problem, as well as the maturity of loan and the time necessary for resolving financial difficulties. When developing the policy, the institution may apply the forbearance measures referred to in Annex 5 to European Banking Authority Guidelines No. EBA/GL/2018/06 "Guidelines on management of non-performing and forborne exposures" (hereinafter – Guidelines No. EBA/GL/2018/06) or other solutions. Institution may also propose other forbearance measures, if it can demonstrate that they are more suitable for the client's situation than the measures referred to in the loan forbearance policy of the institution.

99. If the institution has loan portfolios of loans with shared credit risk characteristics, the institution may define standardised forbearance measures for such loans portfolios, based on the criteria approved in the institution.

100. Institution shall conduct detailed assessment of the financial conditions of the client, in order to determine whether the loan, following the amendments of the agreement, would correspond to the definition of a forborne exposure in accordance with Regulation No. 680/2014. An institution shall assess whether there are any signs of financial difficulties of the borrower, and the institution shall not consider loan collateral or guarantees in such assessment.

101. It shall be considered that the borrower has financial difficulties, if at least one of the following features has been observed during the three months prior to amendments in the client agreement:

101.1. the client has been more than 30 days past due;

101.2. the loan is included on the watch list of loans with early signs of deteriorating quality;

101.3. increase in probability of default (PD) of the borrower in or decrease in other loan quality evaluation indicator since the previous assessment in internal rating system of the institution;

101.4. market conditions have changed significantly in a way that could impact the borrower's ability to repay.

102. Prior to making decision on the most appropriate and sustainable loan recovery solution and most suitable forbearance measures for the respective borrower and prior to communicating the solution offered by the institution to the borrower, the institution shall:

102.1. assess the financial condition of the borrower in accordance with last year's financial statements and the latest updated financial information, *inter alia*, shall assess the debt servicing capacity of the borrower and the total amount of debt, analysing the same information as the one that has been used during the loan granting process. If the financial statements of the borrower have been audited or reviewed, the institution shall use mainly the audited financial information in its assessment;

102.2. assess the cause, severity and expected duration of financial difficulties;

102.3. establish possible forbearance measures or a combination of various forbearance measures and conduct the viability assessment hereof in accordance with Points 103 and 104 of this Regulation;

102.4. compare the net present value (hereinafter - NPV) of future cash flows with envisaged forbearance solution, and NPV of enforcement or foreclosure of collateral or other solutions for recovery of loan, if the institution intends to apply such solutions. An institution shall consider historical data for parameters used in calculations, for example, expected liquidation period, discount rate and sales expenses.

103. Institution shall conduct viability assessment of forbearance measures and shall apply forbearance measures only when the following conditions are met:

103.1. the selected solution improves long term the repayment estimate of all outstanding obligations , as compared to unmodified contractual conditions, and repayment of a significant part of the loan is expected in the medium term (at least the amount of the past-due payments or amounts written-off as part of the forbearance solution, if the payment has not been past-due);

103.2. an institution has financial information or other evidence demonstrating that the client can financially afford the selected forbearance measures;

103.3. if forbearance measures have been granted to the loan before, the institution shall ensure the risk control function is involved ex-ante of recurring forbearance measures, and a decision on application of recurring forbearance measures shall be adopted by the management of the institution or a committee that includes at least one executive board member;

103.4. the application of forbearance measures does not result in multiple consecutive forbearance measures being granted to the same exposure, before the loan returns to performing status.

104. Institution shall apply such forbearance measures as reduced principal payment over a defined period, payment of interest only, interest capitalization and other measures intended for aversion of short-term financial difficulties and are temporary, namely, the duration does not exceed one year for construction of commercial property and project finance exposures, and two years for other exposures, only when the following conditions are met:

104.1. the institution can prove that the client experiences short-term liquidity problems and the cash flow would improve in the long-term to the extent that after the end of application of short-term forbearance measures the client would be able to service its loan obligations in full, or there is a significant uncertainty regarding the financial condition of the client, therefore the decision is adopted not to apply long-term forbearance measures for the time being;

104.2. the client has sound cooperation with the institution, inter alia, the client until the financial difficulties, has paid the loan in accordance with the payment schedule, and the client demonstrates willingness to cooperate with the institution.

105. Institution shall include in the client's agreement an option to modify the forbearance measures and determine the amendments to be applied in cases, where the financial conditions of the client improves to such extent that the client is able to make larger loan payments, however the conditions of the modified agreement may not be less favourable to the client than the initially concluded agreement.. Should the client be unable to meet the conditions provided for in the forborne loan agreement, an institution may request additional collateral from the client.

106. Institution may set special conditions for the client after granting forbearance measures(for example, regular reporting of financial conditions or fulfilment of the set of covenants, agreement concluded that support the current and forecasted cash flows of the borrower, regular status reports of an action plan), to enable the institution to conduct enhanced supervision of the quality of forborne loans. Institution shall conduct enhanced supervision at least during the probation period.

107. Institution shall conduct regular (at least annual) assessment of effectiveness of forbearance measures and their granting process with respect to both performing and non-performing loans, to ensure that the granting of forbearance measures does not postpone the essentially unrecoverable payments. The assessment of effectiveness of forbearance measures shall be conducted to a sufficient detail taking into account the specifics of the loan portfolio of the institution and the number of forborne loans, to enable the management of the institution to obtain comprehensive information regarding the short-term and long-term effectiveness of forbearance measures. In the assessment, the institution shall consider at least the following indicators:

107.1. cure rate and re-default rate of forborne loans and the causes thereof;

107.2. cash collection rate from forborne loans;

107.3. amounts (parts of loans) written-off the balance sheet as a result of forbearance measures granted.

Linking forbearance measures to the NPL status

108. Loans classified as NPL before the application of forbearance measures shall maintain the NPL status also after the application of forbearance measures. After the expiry of the probation period, an institution shall conduct an assessment of the financial conditions of the borrower, to make sure that the circumstances for classifying the loan as the NPL in accordance with the conditions referred to in Regulation No. 640/2014 no longer exist.

109. Institution shall set criteria for the minimum amount of payments (interest and principal) to be made during the cure period after the application of forbearance measures, to clear the NPL and forborne status. The minimum amount of payments shall not be less than the amounts past-due before the application of forbearance measures or amounts written off as a result of concessions granted. Should the borrower have also other exposures with the institution which are not the subject to forbearance arrangement, the institution should consider the performance of these exposures in its assessment of the borrower's ability to comply with post-forbearance conditions.

110. Institution shall assess those loans classified as performing before application of forbearance measures, to ensure that do not meet the conditions to be reclassified as NPL according to the following indicators:

110.1. the forbearance agreement contains clauses that postpone loan payments over an extended time period (more than two years), by granting the grace period;

110.2. future cash flows are not sufficient to cover the payments set out in the payment schedule, which is confirmed by a repeated failure to comply with the payment schedule, changes to the payment schedule to avoid breaches, future cash flows are not sufficiently prudent with respect to the repayment capability and willingness of the borrower or future macroeconomic outlook.

111. Institution shall conduct an assessment of the financial condition of the borrower, to ensure that the circumstances for classifying the loan as the forborne in accordance with the Regulation No. 640/2014 no longer exist.

VIII. Asset quality evaluation and provisioning

112. Institution shall establish an asset quality evaluation system, in order to assess the asset quality on timely basis and estimate the expected losses in accordance with the policies and procedures of an institution, taking into account the requirements of this Regulation, and to create provisions in accordance with the accounting standards.

113. Institution shall regularly evaluate the quality of assets, based on comprehensive, well-documented and consistently applied analysis of asset portfolio, using professional judgment and reasonable assumptions and considering all available internal and external information about historical and current conditions, as well as forward-looking information, that affect the asset quality.

114. Institution shall develop and document the methodology for the asset quality evaluation and provisioning (hereinafter - methodology), in order to prudently estimate the expected losses and determine the provisions to be recognised in the financial statements at the reporting date. Methodology shall be documented in the policies and procedures of the institution. Institution shall, as far as possible, use the same data, processes and data processing tools for calculating the expected losses for the purposes of accounting and capital adequacy calculation. The

institution shall review and update the applied methodology on a regular basis, in line with the changes in the strategy and economic conditions of the institution.

115. The management of an institution shall be in charge of establishment and effective operation of the asset quality evaluation system, and it shall approve and review the policies and procedures of the institution on a regular basis, as well as shall appoint the employees or units in charge of the implementation of those policies and procedures.

Criteria for individual evaluation of assets

116. Institution shall evaluate the assets that are individually significant on an individual basis. Institution shall assess other assets either on an individual basis, or by grouping assets with shared credit risk characteristics.

117. Institution shall develop and document criteria for determining assets which shall be assessed on an individual basis. When setting the criteria, the institution shall consider the absolute amount of the asset and its relative share versus total assets, loan portfolio, securities portfolio or own funds. Institution shall consider such qualitative indicators as elevated country risk, elevated industry risk and affiliation of the person with the institution. An institution shall also consider whether its portfolio contains assets with similar risk profile and whether there is historical data available, to enable asset evaluation in groups.

118. Institution shall evaluate NPLs on an individual basis, except where in accordance with the methodology developed by the institution the assets may be assessed in groups, because they are small and the costs of individual evaluation are disproportionate, in comparison to the amount of potential losses.

119. If the institution has several assets with the counterparty and one of those assets is an NPL, the institution shall act in accordance with Annex V of Regulation No. 680/2014.

120. Where an asset meets the criteria of an asset evaluated on an individual basis, but it is classified as a performing asset, the institution shall include it in a group of assets with shared credit risk characteristics and shall assess it as a group, in order to estimated impairment loss. If the institution does not have (it cannot form) asset groups with shared credit risk characteristics, it shall evaluate the assets on an individual basis only.

121. For forborne assets the impairment loss incurred by the institution, shall be estimated using the future cash flows after granting forbearance measures and using the original effective interest rate of the asset before amendments in the contract for discounting.

Individual evaluation of assets

122. Institution shall estimate the lifetime expected losses as the difference between the contractual cash flows that are due to the institution under the contract and the future cash flows it expects to receive from the asset, applying probability-weights to various scenarios, discounted in accordance with the requirements of accounting standards.

123. The future cash flow estimate shall be the best estimate of the institution, which shall take into account all information available to the institution at the time of preparation of the estimate, including forward-looking information, and shall be based on reasonable and justified assumptions and forecasts that are duly documented.

124. The future cash flows of loans evaluated on an individual basis shall be estimated using the following principles:

124.1. going concern principle implies that the cash flow from operating activities of the borrower or issuer of the guarantee is sufficient to cover the existing obligations. Revenue from the sale of collateral shall be considered only to the extent it does not influence the operating cash flows. This principle shall be used in cases, where the expected future operating cash flows are material and it can be reliably estimated;

124.2. the gone concern principle implies that the future operating cash flows of the borrower cannot be forecasted or are not sufficient to over major part of the loan obligations, and the collateral shall be enforced or foreclosed. This principle shall be used at least in those cases, which meet one of the following criteria:

124.2.1. significant loan payments have been past-due for a long period;

124.2.2. future operating cash flows are estimated to be negative or insignificant compared to the amount of loan obligations;

124.2.3. it is not possible to estimate the expected future cash flows reliably or the institution does not possess sufficient information, to perform the future cash flow analysis on going concern basis.

Application of going concern principle

125. When using the going concern principle in the estimate of the future operating cash flows, the institution shall consider the following factors:

125.1. the institution has access to the borrower's business plan and updated and reliable information on the expected cash flows;

125.2. future operating cash flows are supported by financial statements of the borrower. Detailed cash flows shall be outlined with a time horizon of three to five years (applying the prudence principle), afterwards assuming steady cash flows. Future cash flow estimate shall consider the impact of business restructuring plan, if applicable, and the risk that the borrower re-default in the future, based of the expected credit standing of the borrower;

125.3. information available in financial statements shall be adjusted to exclude the factors, which affected the information in the financial statements (for example, one-off transactions, changes in accounting policy), but which are not applicable for the future cash flow;

125.4. if loan recoverability depends on sale of assets owned by the borrower, the future cash flows shall be calculated, considering both the projected sales revenue and the sales costs, if they are material.

126. Institution shall calculate the recoverable value of the loan, using going concern principle using one of the following approaches: detailed cash flow analysis, steady state approach or two step cash flow approach. An institution shall apply the selected principle consistently and change it only when it is justified.

127. Detailed cash flow approach may be used for all loans, especially, for commercial and residential real estate projects, when sale of the real estate is expected , and for long-term shipping projects.

128. Steady state approach shall be used in cases, where the operating cash flows of the borrower are positive and steady. The institution shall use the borrower’s earnings before interest, tax, depreciation and amortisation (EBITDA), which shall be multiplied by a multiplier. A multiplier

applied by the institution shall not exceed "12" for infrastructure projects, "10" – for public utilities projects and "6" – for other projects. If the borrower has several loans, including also other institutions, the cash flows shall be allocated among all such loans.

129. A two-step cash flow approach shall be used in cases, where the earnings of the borrower are not steady (i.e., the project is in initial or development stage, restructuring is in progress). The institution shall assess the expected cash flows for each period separately and, at the end of the last period, shall estimate the terminal value, by applying multiplier to the last period assessed in detail as per steady state approach or applying the gone concern principle.

Application of gone concern principle

130. Where the gone concern principle is applied, the recoverable amount of the loan shall be the cash flow that would result from sale of collateral less the sales expenses, which shall be discounted, by applying the effective interest rate of the loan in accordance with accounting standards.

131. The recoverable amount shall be calculated according to the following formula:

$$Atgūstamā\ vērtība = nodrošinājums\ (\%) * \sum_{t=0}^{T} \left(\frac{Ieņēmumi_t - izdevumi_t)}{(1+EIR)^t} \right),$$

Atgūstamā vērtība - recoverable amount

Nodrošinājums – collateral

Ieņēmumi - income

Izdevumi - expense

where:

collateral (%) - part of collateral, to which an institution has preemptive rights to the income from sale of collateral;

T - expected time from the date of estimate until the sale of collateral, that is derived from the time between the default event and the sale of collateral (time to sell) based on historical experience of the institution as.

income - expected income from sale of collateral by year, including the income from the collateral until the moment of sale;

expenses - expenses related to the sale of the object by years, including legal costs, fees and costs related to maintenance of collateral until the sale, as well as market price haircut, reflecting market liquidity for such objects and the selected sales strategy. Institution shall determine the market price haircut, based on its historical experience and considering the technical condition and location of the collateral, as well as the date of the last valuation. Should an institution, in an

exceptional case, not apply the market price haircut, it shall document the justification of such decision;

EIR - effective interest rate of the loan in accordance with accounting standards.

132. Cash flow for the loan according to the gone concern principle shall be estimated, considering:

132.1. the existence of collateral insurance;

132.2. future economic forecasts, based on recognised and reliable sources, applying the prudence principle;

132.3. that the enforcement of financial guarantee shall be considered in the calculation of recoverable cash flows only, if an institution has reliable information on creditworthiness of the guarantee issuer and the ability to enforce the guarantee.

Immovable property collateral valuation for for non-performing loans

133. Immovable property collateral valuation for NPLs shall be carried out for each property individually.

134. The property valuation referred to in Point 133 of this Regulation shall be performed by an independent internal or external appraiser in accordance with Latvian property valuation standards, European property valuation standards or international property valuation standards, when the loan is classified as NPL. Where a valuation meeting the requirements of this Regulation has taken place within the past 12 months before obtaining NPL status, institution shall not be required to perform a recurring valuation for such collateral. For commercial properties the value shall be updated at least annually, for residential properties - at least once in three years, while the loan keeps the NPL status. Institution shall ensure more frequent valuation where a significant decrease in immovable property value is observed on the market or where there are indications of sharp decline in the value of any individual loan collateral.

135. Institution may apply indexation or other statistical methods for recording decrease in the value of immovable property, where the sum of outstanding obligations of NPL does not exceed 300,000 EUR and the valuation methods are appropriate to the type of collateral. Indexation may be applied also to immovable properties with a previous valuation having taken place within the past 12 months for update of the immovable property value at the moment of impairment loss calculation.

136. Where an institution applies indexation method, it shall ascertain that the indices used are reviewed on a regular basis, they are applicable to the relevant type of immovable property and based upon actual immovable property transactions over a sufficient time period.

137. Institution shall approve a list of its internal and external appraisers and shall ensure that the appraisers comply with the following criteria:

137.1. the appraiser is not involved in the loan granting process;

137.2. the appraiser is not influenced by the borrower’ s creditworthiness, when valuing the property;

137.3. the appraiser has no conflict of interest regarding the property to be valued and the appraiser is not a connected to either the buyer or the seller of the property;

137.4. the fee of the appraiser is not linked to the result of the valuation or the value of immovable property;

137.5. the appraiser provides an objective, sufficiently justified and clear valuation report.

138. The same appraiser shall carry out no more than three consecutive valuations of the immovable property, including value update valuation. Afterwards, an institution shall ensure rotation of appraisers.

139. Institution shall challenge the quality of the valuations provided by the immovable property appraisers and involve the risk control and internal audit function in the process of selection of appraisers and assessment of the quality of valuations. Institution shall ensure that the appraisers comply to the conditions of Point 137 of this Regulation and shall compare the valuations with market data on a regular basis.

140. Institution shall regularly compare and document (carry out back-testing) the assumptions applied in immovable property valuation (*inter alia*, the haircut rate applied for a valuation performed by an independent appraiser) with the market and institution's data on the sale of similar objects, applying the results of the test to the assets on the balance sheet.

141. Institution shall keep in the credit file information about immovable properties pledged as loan collateral, foreclosed immovable properties, as well as information on transactions concluded with respect to such properties, specifying the type, technical condition, size, location (full address) and value of the immovable property, valuation date of all historical valuations, appraiser, valuation method, sales price, *inter alia*, specifying whether the sale was a fire sale.

142. Institution shall document information about each asset evaluated on an individual basis, in line with the requirements set out in Annex 2 to this Regulation.

Assets subject to collective assessment

143. For the purposes of the estimating impairment allowances, assets that not assessed individually shall be grouped based upon shared credit risk characteristics, for example, internal asset classification categories, which, in turn, take into account the asset type, industry or market segment, geographical location, information about the income and income stability of the counterparty, overdue payments, information about forbearance and other factors. NPLs shall not be grouped together with performing assets. The selected risk parameters are important for the future cash flow estimation of the asset group, because they characterise the ability of the counterparty to fulfil its liabilities in accordance with the conditions of the contract.

144. Institution shall use information on historical loss for future cash flow estimation and shall ensure that the information on historical loss is applied to the asset groups that share similar credit risk parameters with those groups whose historical loss rate is being used. The method applied by the institution shall ensure the possibility to refer information on historical loss formed for the asset groups with shared credit risk characteristics, and the corresponding data reflecting the current conditions to each asset group.

145. The institution shall adjust the historical loss rate based on current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and remove the effects of conditions in the historical period that no longer exist, and shall take into account:

145.1. changes in the asset portfolio, risk profile and the contractual conditions;

145.2. any asset concentration and changes in the level of concentration;

145.3. changes in the volume of the past due assets, changes in the number of the high-risk assets, forborne assets and other assets with modified contractual conditions, the trends and relevance of these changes;

145.4. changes in international and local economic and business conditions.

146. Institution shall develop methodology for estimating impairment provisions for asset groups, considering the following factors:

146.1. parameters used in methodology shall be based on time series data, based on verifiable and numerical information, with a minimum level of management or expert judgement;

146.2. the parameters used shall reflect the key characteristics of each asset group, especially where the institution estimates loss given default (LGD), cure rates and re-default rates;

146.3. economic indicators used in the methodology shall include factors that impact amount of expected loss, inter alia, macroeconomic indicators, expected duration of court procedures, expected legislative changes, as well as the economic and business development outlook;

146.4. the institution shall also consider the expected changes in the risk profile of the institution as a whole, changes in its lending, forbearance, loan write-off and recovery policies.

147. Institution may use internal and external statistical databases, where it can demonstrate that such data are applicable to the relevant asset group.

148. The recognition of impairment for a group of assets, based on a collective assessment, shall be the interim stage for the recognition of impairment of those assets on an individual basis. Where the institution has information demonstrating a significant credit risk increase fora specific asset included in the group, such asset shall be excluded from the group and assessed on an individual basis or included in another group, in line with the risk characteristics of the asset.

149. Institution shall regularly review grouping of assets in light of the economic conditions and the strategy of the institution and shall introduce temporary or permanent changes in loan groups, as necessary.

150. Institution shall document information about each asset group in line with the requirements set out in Annex 2 to this Regulation.

Income recognition

151. Institution shall recognise interest income in accordance with the accounting standards and shall ensure information in its internal records regarding interest, which has been:

151.1. accrued for NPLs;

151.2. accrued for forborne assets more than 90 days past due at the moment of forbearance, and, irrespective of the duration of arrears at the moment of forbearance, for forborne assets subject to repeated forbearance within a period of one year;

151.3. capitalized via asset forbearance;

151.4. accrued for forborne assets within the period of two years following the forbearance.

152. Information on interest referred to in Point 151 of this Regulation shall be taken into account, when calculating own funds in accordance with the conditions of Point 161 of this Regulation.

Reversal of impairment provisions

153. Impairment losses shall be reversed, where there is objective evidence that the impairment is lower than previously estimated, using information available at the time of the previous calculation. Indications for the loss reduction are as follows:

153.1. a counterparty has repaid a substantially larger amount than anticipated in the previous impairment loss calculation;

153.2. current and projected cash flow of a counterparty is positive and sound;

153.3. a counterparty has provided additional collateral since the previous impairment loss calculation, thus significantly increasing the total collateral value.

Write-off of unrecoverable assets

154. Where the institution deems an asset or part of an asset unrecoverable, it shall write off the asset or part of it from the balance sheet on timely basis. Institution shall assess long-term recoverability of assets, focusing attention on assets past due for a prolonged period of time and those assets that subject to insolvency proceedings. Institution shall set the maximum time period for non-performing asset, an unsecured asset or an unsecured part of an asset to be provided for in full (100%) and shall write off such asset or part of it from the balance sheet.

155. Institution shall store information about the loans written off from the balance sheet and the institution shall keep the legal right to recover such loans.

Valuation of foreclosed assets

156. Institution shall generally classify and assess the foreclosed assets as assets held for sale under International Financial Reporting Standard (IFRS) 5, because the institution repossesses such assets as a result of default of a loan, i.e., such assets shall be deemed an extension of a problematic lending exposure and the repossession of the collateral has not been part of the initial lending arrangement. Where an institution, as an exception, classifies the foreclosed asset as investment property in accordance with accounting standards, an institution shall document the justification of such decision. When the fair value of a foreclosed asset is based level 2 or 3 data in fair value determination hierarchy, in accordance with the accounting standards, the institution shall assess the need to apply haircut, depending on the location, condition of the asset and market activity, as well as the duration of presence of the asset on the balance sheet of the institution. Institution shall carry out valuation of the foreclosed assets under the procedure set out in Point 134 and Points 137–141 of this Regulation. If the institution holds a foreclosed asset on the balance sheet for more than five years, the institution shall apply a haircut in the amount of at least 30 per cent of the fair value of the property determined in accordance with the requirements of International Financial Reporting Standard (IFRS) 13, and shall prepare and submit to the Commission an enforcement plan in accordance with the requirements of Point 208 of this Regulation. An institution shall recognise the haircut referred to in this Point in the financial statements or shall apply it as CET 1 adjustment in accordance with requirements of Point 161 of this Regulation.

Valuation of off-balance-sheet items

157. An institution shall assess the guarantees issued by an institution, unused credit lines, as well as other exposures subject to credit risk and recorded in off-balance-sheet, and shall create impairment provisions for them in accordance with the accounting standards, and shall use historical data to support its assumptions, as well as shall back-test the estimated loss with the actual loss in accordance with Point 95 of this Regulation.

Commission's approach to the evaluation of asset quality and provisioning

158. When assessing institution's asset portfolio quality, methodology and adequacy of the impairment provisions, the Commission shall rely upon the analysis of information and reports filed by the institution, and shall consider, whether:

158.1. the asset quality verification system in an institution is effective and ensures timely identification of deterioration in asset quality, monitoring of problematic loans and timely and appropriate measures;

158.2. the management of the institution is regularly informed about the quality of the asset portfolio, impairment provisions and the necessary additional capital needed for covering expected loss (incl., own funds adjustments);

158.3. assumptions, estimates and conclusions of the institution are reasonable and duly justified and documented;

158.4. the methodology of the institution ensures that the impairment provisions are prudently estimated and recognised on timely basis and the institution makes accurate assessment of the expected loss, namely:

158.4.1. the procedure applied by an institution for estimating impairment provisions for assets evaluated on an individual basis, is prudent and based on future cash flow estimate , that complies with the requirements of this Regulation;

158.4.2. institution's approach to estimating impairment provisions is justified;

158.4.3. the total amount of impairment provisions and own funds adjustments is sufficient, taking into account the total credit risk in the asset portfolio of the institution;

158.4.4. provisioning process and calculation of the adjustment to capital is well documented;

158.4.5. the interest income recognition is prudent;

158.4.6. institution writes off unrecoverable assets from the balance sheet;

158.4.7. the relevant policies, procedures and practices of the institution comply to the requirements of this Regulation;

159. The Commission shall have the grounds to consider the asset quality evaluation process of an institution satisfactory and to agree to its estimates, if the institution:

159.1. maintains an effective asset quality evaluation system for the identification and monitoring of asset quality issues and taking of timely measures in case of asset quality deterioration;

159.2. properly analyses all the relevant qualitative factors affecting the quality of the asset portfolio at the time of the evaluation;

159.3. has set up a procedure for provisioning that complies with the accounting standards for both individual assets and asset groups;

159.4. has included reasonable and justified assumptions, valuations and judgment, when estimating the expected loss.

160. Impairment provisions for asset groups or individual assets shall be considered sufficient, if the institution ensures that:

160.1. For those NPLs that have NPL status for more than one year, but less than two years, the institution shall consider the market or book value of the collateral, and the sales options for the collateral, and shall make full provisions for the unsecured part;

160.2. For NPLs that have NPL status for more than two years, the institution shall deem only immovable property and such collateral types, which correspond to criteria set in Title II, Part Three, Chapter 4 of Regulation No. 575/2013 as effective collateral;

160.3. For NPLs that have NPL status for more than two years and for which the institution holds an effective collateral in accordance with the requirements of Point 160.2 of this Regulation, an institution shall carry out a prudent valuation of collateral and assess annually the need to reduce the value of the collateral, considering the sales options of collateral and related expenses, however the provisions shall exceed 3 per cent in the fourth year, 12 per cent in the fifth year, 30 per cent in the sixth year and 60 per cent in the seventh year;

160.4. For the purposes of calculation of the unsecured part of NPL, the minimum reduction specified in Point 160.3 of this Regulation shall be applied to the lowest of the following collateral valuations:

160.4.1. to the most recent collateral valuation carried out before the asset has been classified as NPL;

160.4.2. to the last updated collateral valuation;

160.5. For NPLs that have NPL status for more than seven years, an institution shall make provisions in the amount of 100% of the full residual asset value, including the secured part.

161. If the amount of provisions recognised in the financial statements of the institution is not sufficient to cover the expected loss, the Commission, by using the prudence concept and taking into account the risk profile of an institution, shall require the institution to form additional provisions for estimated expected loss in the financial statements or perform CET 1 adjustment in supervisory reports for the estimated excess of the expected loss over the provisions formed in the financial statements, reduced by the multiplication of the estimated excess of the expected loss with the risk level determined for the exposure, for which the expected loss has been estimated, and 8 (eight) per cent. Institution that applies standardised approach for calculating the weighted average exposure amounts, shall insert the adjustment in Row "524" of Template "C 01.00 – OWN FUNDS (CA1)"of Regulation No. 680/2014 in accordance with Article 3 of Regulation No. 575/2013.

IX. Additional requirements for institutions with high share of non-performing loans

General requirements

162. Institution shall calculate non-performing loans ratio (hereinafter – the NPL ratio) at the end of each quarter, using the EBA risk indicator methodological guide and on the basis of data in Template "F 18.00.a (NPE) information on non-performing and performing exposures" of Regulation No. 680/2014. In accordance with the methodology, non-performing loans and advances at amortised cost, at fair value through comprehensive income and at fair value through profit or loss shall be used in the numerator, and all loans and advances classified at amortised cost, at fair value through comprehensive income and at fair value through profit or loss (gross carrying amount loans and advances) shall be used in denominator. Institution shall calculate the NPL ratio using data from consolidated and individual supervisory reports.

163. Institution shall perform assessment of operating environment, prepare and implement NPL management strategy and strategy implementation plan and shall comply with the requirements laid down in this Chapter with respect to NPL management, if the institution meets one of the following criteria:

163.1. total NPL ratio of the institution is above 5% on an individual, sub-consolidated or consolidated group level for two subsequent quarters;

163.2. total NPL ratio of the institution is below 5%, but the institution has significant NPL concentration in a loan portfolio, in loans issued for an industry, group of connected clients or in a geographical region.

164. Where the portfolio of loans issued to non-financial corporates (NFCs) and households does not exceed 20% of the total assets of the institution, the number of NPLs is insignificant and NPL increase is of a short-term nature, institution may be exempt from the requirements set out in Point 163 of this Regulation after obtaining agreement from the Commission.

165. The Commission may require an institution to prepare and implement the NPL strategy and governance requirements referred to in Point 163 of this Regulation, if it observes loan quality deterioration signs during the supervisory process – significant inflow of new NPLs, significant increase of forbearance measures, significant increase of foreclosed assets, low loss coverage ratios, failure to address early warning indicators or insufficient loan forbearance activities.

166. Institution shall submit report on assessment of operating environment, NPL strategy and strategy implementation plan to the Commission within six months from meeting the criteria referred to in Point 163 of this Regulation. Subsequently the institution shall submit an updated assessment of the operating environment, update to the strategy and strategy implementation plan for the next year, on an annual basis, together with the report prepared in accordance with the Commission Regulation on Capital Adequacy Assessment Process. Where the criteria set in Point 163 of this Regulation has not been met for two subsequent quarters, institution shall stop submitting the report on assessment of operating environment, NPL management strategy and strategy implementation plan to the Commission.

167. An institution shall implement the requirements of this Chapter in accordance with the size of an institution, nature and complexity of its operations, as well as the share, concentration and specifics of NPL, inter alia, loan type (for example, natural or legal persons, small and medium-sized enterprises) and collateral.

Operating environment assessment report

168. Prior to preparation of the NPL strategy, institution shall perform assessment of operating environment, where it shall:

168.1. assess the effectiveness of its NPL management practices, including forborne NPL management, and recovery loans and shall assess in detail the amount of NPL and its causes, as well as analyse the drivers and correlations or NPL inflows and outflows;

168.2. assess the adequacy of internal resources, including the processes and tools applied, data quality, process automation level, staff experience and competence, decision-making, internal policy at least in the following phases of credit risk management process:

168.2.1. early warning on loan quality deterioration and granting of NPL status;

168.2.2. application of forbearance measures;

168.2.3. provisioning and write-off of loans from the balance sheet;

168.2.4. NPL collateral valuation;

168.2.5. loan recovery, litigation processes and foreclosure of collateral;

168.2.6. management of foreclosed assets;

168.2.7. quality of credit risk reports;

168.2.8. NPL monitoring and the effectiveness of NPL workout solutions.

168.3. perform assessment of external operating environment, including at least the following factors:

168.3.1. macroeconomic conditions, taking into account the specifics of NPL portfolio of an institution, including the dynamics of the real estate market or development trends of industries where institution has significant exposure,;

168.3.2. regulatory, legal and judicial framework in jurisdictions, where borrower or collateral is located, including the average duration of legal proceedings, expected outcome of legal proceedings, the rankings of exposures (secured and unsecured exposures) and its implications for legal process outcome, the impact of the types and rankings of collateral and guarantees (for example, second or third priority claim rights and personal guarantees) on the outcome of legal process, the impact of consumer protection issues on court decisions (in particular, for loans to natural persons, where the repayment is secured by real estate (residential) mortgage), and the average total costs of legal proceedings.

169. In addition to the aspects referred to in Point 168 of this Regulation, institution may also assess the following areas, if they are applicable to the institution and implementation of NPL strategy:

169.1. market expectations with regard to acceptable NPL ratios and coverage, including the expectations of rating agencies, market analysts, market study providers and clients;

169.2. trends and dynamics of domestic and international NPL markets with respect to sale of loans or loan portfolios;

169.3. availability of services in NPL servicing industry;

169.4. implications of tax regulation for provisioning and NPL write-off.

170. Based on the assessment in Point 168 of this Regulation, institution shall prepare the operating environment assessment report, covering the self-assessment results, outlining the

strengths of the institution and specifying the areas for improvement to successfully implement the NPL strategy.

171. Risk control function of the institution or an external independent expert shall perform regular assessment of whether the resources of the institution are sufficient for effective NPL management.

Content of NPL strategy

172. NPL management strategy of the institution is part of the overall strategy of the institution, and it is aligned with the internal capital and liquidity adequacy assessment process (ICAAP and ILAAP), the risk appetite of an institution for reaching its strategic targets, recovery plan, remuneration policy and budget of the institution, considering potential losses that might occur within the NPL recovery process.

173. Institution shall prepare NPL management strategy, outlining its approach and targets for effective NPL management (maximum loan recovery) and reduction of NPL amount in a clear, effective and realistic manner for each significant NPL or loan group with shared credit risk characteristics in accordance with the specifics of NPL portfolio of the institution. Where the institution has significant foreclosed asset portfolio, it shall include the strategy of sale of the foreclosed assets in NPL management.

174. Institution shall include in its NPL management strategy the following:

174.1. assessment of the impact of strategy implementation on own funds indicators, applying various economic development scenarios and solutions the institution plans to apply, if it would not be able to meet capital requirements in any of the scenarios;

174.2. short, medium and long term strategy implementation plan, selecting the most suitable solution for the relevant loan or group of loans, for example, holding the loan or applying forbearance measures, sale, write-off of unrecoverable assets, foreclosure of collateral, insolvency proceedings, friendly settlement or other solutions. Where the institution concludes, based on assessment, that none of the solutions are effective for the loan or group of loans, institution shall create provisions correspondingly for such loan or group of loans or write it off from the balance sheet as unrecoverable.

174.3. targets set by the institution, showing numeric reduction of the main individual NPLs or groups of loans in the short-term and medium-term, as well as the projected absolute or relative NPL portfolio overall reduction and for the main NPL portfolios, applying the solutions referred to in Point 174.2 of this Regulation. Absolute and relative reduction of NPL portfolios shall be stated both gross and net of provisions. When setting targets for reduction of NPL, institution shall anticipate active work with NPL and shall not rely only upon reduction arising from positive macroeconomic forecasts. Institution shall define, based on historic data and industry benchmarks, the share of those NPL in the main NPL portfolios and institution as a whole, would not be recoverable over short term or medium term, and which shall remain on the balance sheet in the long term.

Operational plan

175. Institution shall outline the implementation of its NPL strategy over short term and medium term in the operational plan, specifying internal factors that impede successful

implementation of the strategy. Institution shall include at least the following elements in the operational plan:

175.1. clear time-bound goals for implementing the targets set in the strategy;

175.2. recovery activities to be carried out on the largest loans or groups of loans;

175.3. recovery process governance, including allocation of responsibilities and procedure for reporting recovery activities and their outcomes;

175.4. indicators for measuring strategy implementation progress;

175.5. staffing and other resource requirements;

175.6. infrastructure enhancements required;

175.7. planned income and expense for the implementation of the NPL strategy;

175.8. internal and external cooperation and communication required to implement the NPL strategy, *inter alia*, informing the staff about the measures included in the NPL strategy and its link to the overall and risk strategy of the institution.

176. Institution shall develop appropriate internal regulatory documents to achieve the targets set by the strategy and operational plan, outlining the allocation of responsibilities and procedure for reporting recovery measures and their effectiveness.

177. Where institution detects significant deviations from the operational plan, it shall report such deviations and their sources to the management of the institution and the Commission.

Role of the management in the NPL governance

178. Management of the institution shall be responsible for the preparation of the assessment of operating environment, implementation of the NPL strategy and governance requirements in an institution. Management of the institution shall approve the NPL management strategy, operating environment assessment report and operational plan.

179. The supervisory board of the institution shall:

179.1. approve and periodically review the NPL strategy, operating environment assessment report prepared in accordance with the requirements of Point 168 of this Regulation, and the operational plan prepared in accordance with the requirements of Point 175 of this Regulation;

179.2. oversee the implementation of the NPL management strategy;

179.3. periodically review the progress in implementation of NPL strategy and achievement of targets set in the operational plan;

179.4. regularly review the report prepared by institution's internal control function on the most significant weaknesses identified in the NPL governance;

179.5. regularly review the report prepared by the institution regarding the achievement of the indicators referred to in Point 191 of this Regulation;

179.6. ensure that the members of the supervisory board collectively have sufficient knowledge and experience regarding management of NPLs and, they devote sufficient time to NPL issues.

180. The executive board of the institution shall:

180.1. regularly review the progress in NPL strategy implementation and achievement of the targets set in the operational plan;

180.2. define qualitative and quantitative criteria and objectives for the employees responsible for loan recovery;

180.3. approve the loan recovery solutions for the largest exposures;

180.4. approve and at least annually review the policies related to loan recovery and shall inform the employees the content of the policies;

180.5. ensure sufficient internal controls over the NPL governance process, with a special focus on granting and terminating the NPL status, provisioning, write-off of the assets from the balance sheet, collateral valuation and effectiveness of forbearance activities;

180.6. regularly review the report prepared by institution's internal control function on the most significant flaws discovered in the NPL governance;

180.7. regularly review the report prepared by the institution regarding the achievement of indicators referred to in Point 191 of this Regulation;

180.8. ensure that the members of the executive board collectively have sufficient knowledge and experience regarding management of NPLs and they devote sufficient time to NPL issues.

NPL governance

181. Institution shall ensure NPL governance according to the size, nature and complexity of institution's operations, as well as the share and specifics of NPL, *inter alia*, loan type, client segment (for example, natural or legal persons, small and medium-sized enterprises) and collateral.

182. Institution shall set up a separate unit or units engaged in the NPL management. Institution may manage the NPLs in one unit or set up several units tailored to the phases of the loan life cycle - early warning (up to 90 days past due), forborne loans, loan reinforcement, litigation and foreclosure of collateral, management of foreclosed assets.

183. Institution shall ensure sufficient resources in the unit or units referred to in Point 182, inter alia, professionals with appropriate qualification and experience in managing NPLs. Institution shall establish variable part of remuneration for the employees of such units, shall carry out employee performance appraisal and set up employee development plans in accordance with the targets specified in the NPL strategy and operational plan, including mainly quantitative indicators related to the achievement of targets specified in the NPL strategy and operational plan. Institution shall ensure that the performance of the executive board members and other representatives of senior management in charge of the NPL management shall be appraised in accordance with the implementation of the strategy and operational plan.

184. Institution shall clearly define the triggers for handing over into the responsibility of a loan to unit or several units referred to in Point 182 of this Regulation or transferred among the units. Institution shall ensure that the handover process and triggers are clearly defined and deviation from application of such trigger shall be permitted only exceptional cases with appropriate approval.

185. Institution shall ensure that the NPL management function is separated from the loan granting function, *inter alia*, set-up of a separate unit, formal assignment of responsibility for client relations after loan quality deterioration, employees responsible for loan granting are not engaged in the decision-making process, *inter alia*, decisions on loan recovery or forbearance are not adopted by a credit committee. Should it be impossible to fully avoid the engagement of employees involved in the loan granting process in the decision-making regarding loans with

quality deterioration, institution shall develop and implement control procedures ensuring the prevention of existing and potential conflict of interest, *inter alia*, shall define the limits above which decisions are approved by the executive board or another decision-making body specifically established for such purposes, independent from the lending process. Institution shall ensure exchange of information regarding loan quality and recovery results among the employees of units engaged in loan granting and loan recovery.

186. Institution shall ensure information system appropriate for the size and specifics of its NPLs, where complete and regularly updated information is available regarding each NPL and loans with quality deterioration signs, inter alia, information about the borrower and connected persons, as well as the collateral and guarantees received, forbearance measures taken, information on relations with client and payments received. Internal audit or an independent external expert shall regularly verify the information system, including data quality.

187. Where an institution itself lacks sufficient resources for NPL management, institution shall attract independent, qualified external experts. Where the institution outsources part of the NPL management, it shall ensure monitoring of the quality and effectiveness of the outsourced services.

188. Institution's risk control function shall supervise the measurement of the risk caused by NPLs in the institution as a whole and in the main portfolios that have high share of NPLs, *inter alia*, measurement of the impact of such risk on capital adequacy assessment process, as well as shall evaluate the NPL management model as a whole and the its most significant elements, and shall engage in assessing major exposures with high risk and complexity, before the institution decides on concluding a transaction (for example, repeated long-term forbearance measures, significant asset write-off, collateral valuation). Institution's risk control function shall also supervise the operation and effectiveness of early warning system (how effectively the set of indicators for early warning on loan quality deterioration and measures taken by the institution at an early stage improve loan recovery).

189. Institution's compliance function shall regularly assess the compliance of the NPL management processes with the overall policy of the institution and laws, regulations and standards in the area of compliance. Compliance function shall assess at least the granting of NPL status, collateral valuation, application of forbearance measures and operation of early warning system, write-off of unrecoverable loans, as well as the application of definition of default in the institution.

190. Institution's internal audit function shall perform regular audits and ascertain that the institution's NPL management practice complies with internal regulatory documents of the institution, and shall report findings and weaknesses identified to the supervisory board of the institution. The frequency and scope of audits shall be decided based on the volume of NPLs and the significance of deficiencies identified during previous audits.

191. Institution shall define key performance indicators for analysis of NPLs, which the institution shall regularly compare with the targets specified in the operational plan, as well as use them in loan pricing and estimates of expected losses. When defining the indicators, the institution may use the indicators referred to in Annex 2 to Guidelines EBA/GL/2018/06 or other performance indicators, if they are more suitable to the activities of the institution. Reports to the management of the institution shall include at least the following indicators in the institution as a whole and in the most significant loan portfolios:

191.1. NPL ratio, level of foreclosed assets, the amount loans less than 90 days past due, comparison to the budget, NPL strategy and operational plan.

191.2. information about the provisions for NPLs, type of collateral and its value, coverage ratio, duration of the NPL status, expected time to recovery;

191.3. changes in the level of NPLs, *inter alia*, newly classified NPLs and loans with cured NPL's, number and amount of forborne NPLs, loans up to 90 days past due loans;

191.4. information about loans on watch-list with the early quality deterioration signs, especially loans demonstrating further quality deterioration trends, and large exposures;

191.5. information about the forbearance measures, inter alia, exposures with *debt to asset swap*, and repeated forbearance activities, to assess their effectiveness;

191.6. interest income from NPLs recognised in the statement of profit or loss;

191.7. information about loans under recovery, *inter alia*, the volume of loans recovered during the relevant period, recovered value, type of recovery, expected duration of the recovery process;

191.8. number of foreclosed properties and movement during the reporting period, *inter alia*, results of sales, holding periods and back-test, profit or loss from sales of foreclosed properties.

X. Credit risk stress testing, assessment and prevention of critical situations

192. Institution, when assessing individual loans, shall analyse national economic forecasts and assess potential critical situations, namely, such adverse internal and external conditions that may cause material loss to the institution. Credit risk shall be significantly affected by fluctuations and trends in certain macroeconomic indicators. Therefore, institution shall analyse the impact of such macroeconomic indicators on loans, their profitability, default probability, capital requirement for covering potential loss or availability of other resources and their prices to withstand critical situations. The analysis shall be embedded in the credit risk management decisions.

193. Institution shall perform credit risk stress testing at least semi-annually to assess own funds requirement for credit risk and identify potential critical situations (for instance, the general economic downturn or decline in particular industries financed by the institution, unforeseen increase in defaulted loans, adverse circumstances that may cause substantial correlation of various risks, in particular, credit risk and market risk, potential risk spill overs among institutions).

194. Institution shall develop stress testing methodology, scenarios and parameters and after approval by the executive board shall perform credit risk stress testing, analyse the outcome of stress testing and use it in credit risk management, as well as for drawing up and submitting reports to the management of the institution.

195. Institution shall develop such stress scenarios that encompass changes in quantitative and qualitative indicators that affect credit risk for various periods of time and stress levels. The level of credit risk is affected by changes in national macroeconomic indicators, adverse trends in development of particular sectors or extraordinary events that have impact on the implementation of the projects financed, as well as by a significant number of the loans where the borrower's income currency mismatches the loan currency.

196. Stress testing scenarios shall be designed to have a sufficiently significant impact on the institution, however they should not be impossible. The number of stress scenarios and their granularity shall depend on institution's overall volume of credit, diversification, the structure of loan portfolio as well as the size of the institution.

197. Institution shall ensure that credit risk is assessed at various shock levels, namely, from regular sensitivity analysis to stress testing at institution or group level.

198. When performing stress testing, institution shall use various time horizons. Institution shall analyse both potential impact of one-off events and consequences that might be caused by events over a longer period of time.

199. Institution shall provide for at least two periods of long-term stress events in the credit risk stress testing scenarios - changes expected within one year and changes expected over at least two years. Institution shall develop at least two scenarios for credit risk stress testing: a baseline scenario based on the economic forecasts that provide for rather insignificant changes in macroeconomic indicators (gross domestic product, unemployment rate, inflation rate, price movements), and an adverse scenario based on adverse economic development forecasts.

200. Where the results of credit risk stress testing reveal potential loss that may be covered by the excess of own funds available for the coverage of the institution's overall risks, the executive board shall consider possible measures for improving credit risk management to ensure that coverage also in the future. If potential loss cannot be covered by the excess of own funds available, institution shall develop an action plan to ensure the adequacy of capital required for the credit risk or reduce an impact of the potential adverse development scenario used in stress testing.

201. An institution shall consistently perform the assessment of probable occurrence of critical situations, assess its capability of withstanding identified critical situations and analyse implementation options of the action plan based on the change of assumptions underlying one or several variables.

202. Institution shall also ensure stress testing according to the Commission's scenarios and assumptions, if requested.

203. When performing credit risk testing, institution shall apply requirements set out in Guidelines of the European Banking Authority of 19 July 2018 EBA/GL/2018/04 "Guidelines on institutions' stress testing".

XI. Credit risk control

204. An institution shall ensure control over credit risk management according to the requirements of the Commission's regulation governing the establishment of an internal control framework, in order to assess the effectiveness of credit risk management system.

XII. Final Provisions

205. Upon coming into effect of this Regulation, the Commission's Regulation No. 248 of 29 October 2014 "Regulation on Credit Risk Management" and the Commission's Regulation No. 19 of 16 January 2018 "Regulation on Asset Quality Evaluation and Provisioning" shall become null and void.

206. Institutions that have exceeded the threshold referred to in Point 163 of this Regulation on 31 December 2018 shall prepare the operating environment assessment report, NPL management strategy and operational plan and submit them to the Commission by 30 September 2019, as well as shall implement the NPL governance requirements referred to in Chapter IX of this Regulation by 1 January 2020.

207. Requirements referred to in Point 160 of this Regulation shall apply to loans granted until 25 April 2019. Loans granted from 26 April 2019 that are subject to the requirements of Regulation (EU) 2019/630 of the European Parliament and of the Council of 17 April 2019 amending Regulation (EU) No. 575/2013 as regards minimum loss coverage for non-performing exposures, shall be subject to the requirements laid down in Point 160.2 and Point 160.5 of this Regulation provided that the Commission has grounds to believe that the institution fails to comply with the requirements laid down in Point 158 and Point 159 of this Regulation,.

208. Assets foreclosed prior to 1 July 2018 and classified as investment properties in accordance with accounting standards, shall not be subject to the requirements with respect to asset classification referred to in the first and second sentence of Point 156 of this Regulation. Institution shall prepare a sales plan for those assets, which shall be approved by the executive board of the institution and shall include information about the location, type of use, acquisition value, book value of each asset at the moment of preparation of the plan and the method for its estimation, the date and value as per last valuation, haircut rate applied, shall specify the activities performed for realisation of the asset by years from the moment of foreclosure till the preparation of the plan, *inter alia*, previously offered sales prices, expected sales price and sales type, expected time-to-sale with justification, as well as shall include the self-assessment prepared by the institution on the implementation of the plan submitted in the previous year, specifying also the assets sold since the submission of the previous plan. Institution shall submit the plan to the Commission each year together with the report prepared in accordance with the Commission's regulation on the capital adequacy assessment process. Where an institution has not enforced the properties referred to in this Point by 1 January 2023, it shall apply haircut in the amount of at least 30% of the fair value thereof, determined in accordance with the requirements of IFRS 13. Institution shall recognise the haircut referred to in this Point in the financial statements or shall apply it as CET 1 adjustment in accordance with requirements of Point 161 of this Regulation.

209. With respect to the foreclosed properties, which have been held on the balance sheet of the institution for more than five years as at 1 January 2019, institution shall apply haircut in the amount of at least 10% (in 2019), at least 15% (in 2020), at least 20% (in 2021), at least 25% (in 2022) of the fair value of the property determined in accordance with the requirements of IFRS 13. Institution shall recognise the haircut in the financial statements or shall apply it as CET 1 adjustment in accordance with requirements of Point 161 of this Regulation.

210. The requirements referred to in Point 43–54 of this Regulation shall apply not later than from 1 June 2020.

Information on European Union directives and other international documents

The Regulation contains provisions arising from:

1) Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC;

2) Basel Committee on Banking Supervision document: Principles for the Management of Credit Risk, September 2000;

3) Basel Committee on Banking Supervision document: Core Principles for Effective Banking Supervision, September 2012;

4) Guidelines of the European Banking Authority of 12 May 2017 EBA/GL/2017/06 "Guidelines on credit institutions' credit risk management practices and accounting for expected credit losses";

5) "Guidance to banks on non-performing loans" of the European Central Bank, dated May 2017;

6) Guidelines of the European Banking Authority of 23 February 2018 EBA/GL/2017/15 "Guidelines on connected clients under Article 4(1)(39) of Regulation (EU) No. 575/2013;

7) Guidelines of the European Banking Authority of 31 October 2018 EBA/GL/2018/06 "Guidelines on management of non-performing and forborne exposures";

8) Guidelines of the European Banking Authority of 19 July 2018 EBA/GL/2018/04 "Guidelines on institutions' stress testing"

Chairman of the Financial and Capital Market Commission *P. Putniņš*

Annex 1
to the Financial and Capital Market Commission Regulation No. 120, dated 9 July 2019

Internal documents on credit risk management

1. The policy of the institution for execution of transactions with financial instruments with exposure to credit risk shall include the following:

1.1. suitable types of exposures and appropriate limits;

1.2. content of the documents supporting exposures;

1.3. list of suitable counterparties and valuation criteria;

1.4. sources of market information necessary for the assessment of current and potential credit risk of exposures, procedure for retention, models and methods used for the assessment and procedure that describes how the liquidity of such financial instruments is considered in the assessment;

1.5. powers and responsibilities of employees involved in execution of transactions;

1.6. procedure for reporting default on contractual conditions.

2. Credit risk measurement and monitoring policy and procedures of the institution shall include:

2.1. early warning indicators regarding loan quality deterioration and procedure for monitoring loans with early quality deterioration indicators, including decision-making process;

2.2. procedure for application of internal ratings system, *inter alia*, indicators of each rating, criteria for granting and review of rating, employees in charge of maintenance and regular verification of internal ratings system;

2.3. procedure for identification, administration and recovery of loans with significant quality deterioration;

2.4. procedure for calculation of the duration of the loan life cycle, *inter alia*, how the institution considers the prepayment and default risk in determining the duration of the life cycle;

2.5. procedure for valuation of loan collateral (immovable property and movable property, irrespective of meeting the requirements laid down in Articles 208 and 210 of Regulation No. 575/2013;

2.6. the content of reports on credit risk and stress test results including authors and recipients, frequency of submission;

2.7. definitions of the terms used in measuring credit risk, for example, definition of default, loss event, NPL definition;

2.8. credit risk measurement and registration policy for the financial assets purchased or originated credit-impaired in accordance with accounting standards, in order to correctly classify such exposures and ensure regular updates of information regarding expected cash flows from such exposures.

3. Loan granting policy of the institution shall include:

3.1. criteria and limits for loan granting;

3.2. loan granting procedures and procedure for payout to the client;

3.3. powers and responsibilities of the executive board, established committees (credit committees) and staff involved in the loan granting process, *inter alia*, loan granting using automated decision-making processes;

3.4. conditions and limits for granting unsecured loans;

3.5. procedure for setting interest rates and repayment conditions for loans with or without collateral, as well as loans issued in the currency mismatching the borrower's income currency;

3.6. criteria for borrower's creditworthiness evaluation;

3.7. levels of DSTI and DTI ratio for various categories of borrowers;

3.8. accepted collateral, procedures for valuation of various types of collateral and procedure for regular revaluation of collateral;

3.9. LTV limits;

3.10. conditions for setting stricter requirements in loan granting to the borrowers with high credit risk, including the application of stricter DSTI and DTI ratios or LTV limits to borrowers whose income currency mismatches the loan currency;

3.11. procedure for issuing residential loans against future rentals;

3.12. conditions for applying automated decision-making in the loan granting process, *inter alia*, setting such products and limits, where automated decision-making is allowed;

3.1.3. requirements with respect to what shall be documented as part of the loan granting process, *inter alia*, for audit purposes, including the requirements for finalising the loan application process, justification and all related documents underlying the approval or refusal of loan agreement.

4. The methodology of the institution for asset quality evaluation and provisioning process, where the institution documents the analysis performed, explanations and reasoning of calculations, shall include:

4.1. description of methods applied by the institution for measuring credit risk and expected losses and procedure for regular verification and update of the applied methods;

4.2. indicators timely demonstrating significant increase in credit risk for various asset types, and procedure how the institution verifies the effectiveness of the applied approach in demonstrating significant increase in credit risk;

4.3. indicators and criteria applied by the institution for transferring the asset among stages in accordance with accounting standards;

4.4. quantitative and qualitative criteria, how the institution shall identify the assets for assessment of quality deteriorationon an individual basis;

4.5. guidance for future cash flow estimate of the assets to be assessed on an individual basis, discounting and calculation of the original effective interest rate;

4.6. criteria for determination of asset quality improvement and procedure for reversal of provisions in cases, when the quality of asset (asset group) improves;

4.7. criteria and maximum time period for provisioning in the amount of 100% of the unsecured amount and asset write-off from the balance sheet;

4.8. procedure how the assets assessed on an individual basis and with no significant increase in credit risk , shall be grouped, in order to perform additional assessment, and the procedure for assessment of asset groups;

4.9. procedure how the institution determines that forbearance has taken place, *inter alia*, indicators of financial difficulties of a counterparty, granting NPL status and criteria how the asset exits the status of forborne asset. Impairment loss recognition at the moment of forbearance shall also be determined for forborne assets.

4.10. basis for and detailed information about the parameters, calculations and assumptions used in the guidance for forming provisions for loan groups, as well as the procedure, how the institution selects, supervises and assesses the assumptions used;

4.11. procedure for reviewing the consistency of the formed asset groups to the economic conditions and the strategy of the institution;

4.12. procedure how the loan included in the loan group for the purposes of valuation, shall be excluded from the group in accordance with the requirements of Point 148 of this Regulation;

4.13. procedure for performing back-testing of the estimated losses and actual losses and adjusting the estimates, if significant differences are detected between the estimated and actual losses;

4.14. procedure for performing sensitivity analysis of the methods, assumptions and parameters used in the calculation of losses;

4.15. procedure, for performing valuation of immovable property pledged as loan collateral, value updates and quality assurance of the valuation process, inter alia, assessment and, if necessary, adjustment of the assumptions, restrictive factors, forecasts and data used in the valuation performed by an appraiser;

4.16. procedure for estimating the value of foreclosed assets, selling expenses, and applying haircut in accordance with the conditions of Point 156 of this Regulation;

4.17. procedure for performing indexation of the value of immovable properties pledged as loan collateral;

4.18. procedure for determining significant decrease in value in the real estate market;

4.19. methodology for quality assurance and back-testing of internally and externally performed real estate valuations;

4.20. procedure for using forward-looking information for determination of significant increase in credit risk and expected losses, *inter alia*, information sources, time horizon of forecasts applied by the institution, and information on use of data in calculations;

4.21. own funds adjustments, if any, performed in accordance with Point 161 of this Regulation.

5. Loan forbearance policy of the institution shall include:

5.1. indicators of financial difficulties, applied by the institution to determine whether the amendments to the agreement shall be deemed as forbearance;

5.2. description of forbearance measures offered by an institution;

5.3. financial and non-financial information requested by the institution from the borrower for assessment of borrower’s creditworthiness in case of forbearance;

5.4. procedure for performing assessment of the financial condition of the borrower, *inter alia*, minimum indicators for each loan type, in order to offer forbearance;

5.5. procedure for selecting the most suitable forbearance measures for the client, performs the viability assessment of the forbearance measures and approves the forbearance measures;

5.6. procedure for monitoring and assessing viability of forbearance measures and stores information on the forbearance measures taken;

5.7. procedure for determination of cases, when forbearance measures shall not be deemed viable and it shall be necessary to perform other activities;

5.8. procedure for documenting and monitoring the quality of loans, to which forbearance measures have been granted;

5.9. procedure for granting NPL status to the forborne loans;

5.10. pricing policy for forbearance measures;

5.11. procedure for ceasing to apply the NPL status to the forborne loans, *inter alia*, the type of indicators used by the institution to verify the repayment capacity of the borrower following the application of forbearance measures;

5.12. procedure for ceasing to apply the forborne loan status.

6. NPL management policy shall include:

6.1. role and areas of responsibility of each unit engaged in NPL management, as well as procedure for reporting the implementation of the NPL strategy and its operational plan;

6.2. indicators used by the institution to deliver the loan under the responsibility of the unit engaged in the NPL management, or to allocate it among the units engaged in the NPL management process;

6.3. decision-making procedures with respect to loans with quality deterioration indicators, and communication plan with the client, including the client, who does not respond to the communication of the institution or refuses to cooperate with the institution;

6.4. recovery solutions used by the institution for each type of loans;

6.5. procedure and decision-making process, how the institution selects the most appropriate recovery solution for NPL;

6.6. decision-making mechanism for each type of loans, inter alia, the role of internal control function in decision-making and effectiveness monitoring ;

6.7. procedure for adopting the decision on selling or other type of use of the foreclosed properties.

Annex No. 2
to the Financial and Capital Market Commission Regulation No. 120, dated 9 July 2019

Documentation requirements for assets assessed on an individual basis and in group

1. For each asset assessed on individual basis, the institution shall document:
    1.1. justification for assessment on individual basis;
    1.2. justification of the decision to classify the loan as a non-performing;
    1.3. calculation of the amount of provisions for the asset, specifying:
        1.3.1. future cash flow projection prepared in accordance with going concern or gone concern principle, specifying the justification for cash flows, namely, relevant historical information, current factors affecting the projection, information about the counterparty, assumptions and interest rate applied for discounting of the future cash flow;
        1.3.2. where the gone concern principle is applied, the estimate of the cash flow from collateral enforcement, in accordance with the requirements of this Regulation, *inter alia*, collateral valuation methods, applied assumptions and calculations, justification for adjusting the collateral value as compared to the collateral valuation performed by an independent appraiser, confirmation of appraiser's independence and competence, sales expenses, time to sell. Where the institution uses the market price to set the recoverable value, it shall document the exposure price, its source and transaction date.
2. For each asset group the institution shall document:
    2.1. criteria for grouping loans;
    2.2. method applied for setting the provision rate (procedure for setting of the historical loss rate, including the time period for which the loss has been recognised). If the historical loss rate was selected from a range of rates, the institution shall document the procedure of defining such interval and a logical justification that the selected rate is the best estimate within the range;
    2.3. adjustment to the historical loss rate with an explanation on how the adjustment reflects the current information (events, circumstances) and the factors that affected the estimates of loss. The impact of each factor, as well as an explanation on how the institution quantified such impact shall be documented;
    2.4. back-testing of the actual loss against the loss estimates for the asset group and the results of the sensitivity analysis of the assumptions and parameters applied.