CLEARY GOTTLIEB

ALERT MEMORANDUM

COVID-19 – Monetary Stimulus and Relief Measures Announced by the European Central Bank and Member States Banking Authorities

March 25, 2020

In the past days, the European Central Bank ("ECB"):

(1) announced the launch of a new EUR 750 billion temporary program for the purchase of private and public sector securities to "*counter the serious risks to the monetary policy transmission mechanism and the outlook for the euro area posed by the outbreak and escalating diffusion of the coronavirus, COVID-19*" (so-called "Pandemic Emergency Purchase Program" or "PEPP"); and

(2) activated the supervisory and capital relief measures in favor of EU credit institutions, which amounts to €120 billion and could be used to absorb losses or potentially finance up to €1.8 trillion of lending (in addition to measures such as public guarantees provided by various Member States in favor of household and/or corporate borrowers).

This memorandum is intended to give an overview of the monetary stimulus and supervisory relief measures announced by the ECB and banking supervisors in France, Italy and Germany.

These new measures complement the initial measures announced by the ECB on 12 March 2020 (described in our previous alert memorandum)[1] as well as measures adopted by the Member States.[2]

If you have any questions concerning this memorandum, please reach out to your regular firm contact, the following authors or our COVID-19 task force directly by clicking here.

PARIS

Amélie Champsaur
+33 1 40 74 68 95
achampsaur@cgsh.com

Aurèle Delors
+33 1 40 74 69 33
adelors@cgsh.com

Elodie Gianferrara
+33 1 40 74 69 26
egianferrara@cgsh.com

ROME

Giuseppe Scassellati-Sforzolini
+39 06 6952 2220
gscassellati@cgsh.com

Laura Prosperetti
+39 06 6952 2640
lprosperetti@cgsh.com

Bernardo Massella Ducci Teri
+39 06 6952 2290
bmassella@cgsh.com

MILAN

Roberto Bonsignore
+39 02 7260 8230
rbonsignore@cgsh.com

Giulia Rimoldi
+39 02 7260 8268
grimoldi@cgsh.com

FRANKFURT

Michael Kern
T: +49 69 97103 252
mkern@cgsh.com

[1] https://www.clearygottlieb.com/measures-adopted-by-eu-banking-authorities.pdf
[2] E.g., for France, see our alert memorandum: https://www.clearygottlieb.com/news-and-insights/publication-listing/covid-19-first-measures-announced-by-the-french-government

clearygottlieb.com

© Cleary Gottlieb Steen & Hamilton LLP, 2019. All rights reserved.

This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice. Throughout this memorandum, "Cleary Gottlieb" and the "firm" refer to Cleary Gottlieb Steen & Hamilton LLP and its affiliated entities in certain jurisdictions, and the term "offices" includes offices of those affiliated entities.

I. Stimulus Measures

A. Legal framework

Under Article 127 of the Treaty on the Functioning of the European Union ("TFEU"), the European System of Central Banks ("ESCB") has a mandate to (i) maintain price stability within the euro zone and (ii) support the general economic policies in the European Union.

The Statute of the ESCB provides the ECB with tools to attain these objectives, including the possibility to use open market operations, which include: (i) long-term refinancing operations, including the current targeted long-term refinancing operations program launched in March 2019 ("TLTRO-III") as well as (ii) outright purchase transactions within the framework of an asset purchase program ("APP") in accordance with ECB Guideline (UE) 2015/510.

TLTROs

The TLTROs are targeted operations, insofar as the amount that banks can borrow is linked to their loans to non-financial corporations and households.

Under the current TLTRO III, the interest rate is based on the participating banks' lending patterns and specifically on the volume of loans to non-financial corporations and households (excluding mortgages).

Eligible collateral for purposes of TLTROs is assessed by the national central banks according to the criteria specified in the Eurosystem legal framework for monetary policy instruments.

APPs

All national central banks as well as the ECB participate in APPs, which are coordinated centrally by the ECB. Under an APP, the ESCB may decide to target public or private sector securities. The ESCB may only conduct purchases of public securities on the secondary market due to the prohibition of monetary financing set out in Article 123 of the TFEU.

In the context of the euro zone crisis, the legality of a specific APP – the Outright Monetary Transactions Program ("OMT") – was challenged in front of the German Constitutional Court, which referred questions for preliminary ruling to the Court of Justice of the European Union.[3] The Court confirmed the legality of the OMT, ruling that (i) the measures announced as part of this program, which involved the purchase of government bonds of euro area countries, fall within the mandate of the ESCB, and (ii) the ESCB's purchases of public securities on the secondary markets was accompanied by sufficient guarantees to ensure that the ESCB's intervention on the financial markets did not contravene the prohibition of monetary financing.

B. New LTROs and Expansion of Eligible Collateral

On 12 March 2020, the ECB announced:

(i) the introduction of additional LTROs, in order to provide a liquidity "bridge" between March 2020 and the start of the fourth operation of the existing TLTRO-III (i.e., 24 June 2020), at an interest rate equal to the average rate on the deposit facility;[4] and

(ii) the application of more favorable terms to TLTRO-III operations between June 2020 and June 2021, with the aim of supporting the granting of credit facilities to households and businesses that will be most affected by the COVID-19 crisis (with particular regard to SMEs). During this period, the interest rate on TLTRO III operations will be 25 basis points below the average rate applied in the Eurosystem's main refinancing. For counterparties that maintain their levels of credit provision, the rate applied in these operations will be lower, and, over the period ending in June 2021, can be as low as 25 basis points below the average interest rate on the deposit facility operations. The limit of 10% of the stock of eligible loans for the amount of

[3] ECJ, Grand Chamber, 16 June 2015, C-62/14, *Peter Gauweiler and Others*

[4] Calendar available at : https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200312_2~06c32dabd1.en.html

funds that can be borrowed in each operation is removed on all future operations. The maximum total amount that counterparties will be entitled to borrow in TLTRO III operations will be raised from 30% to 50% of their stock of eligible loans as at 28 February 2019.

On 20 March 2020, the ECB announced that it will expand the scope of *eligible collateral* to ensure that counterparties continue to be able to make full use of the funding support. In particular, instruments financing the corporate sector will be accepted as collateral for the purposes of LTROs.

C. Pandemic Emergency Asset Purchase Program

On 12 March 2020, the ECB announced an increase by EUR 120 billion of its envelope for net asset purchases in favor of the private sector to be conducted until the end of 2020.

In addition, on 20 March 2020, the ECB announced a Pandemic Emergency Asset Purchase Program ("PEPP"), with an overall envelope of EUR 750 billion. The ECB announced it was prepared to increase the size of the program if needed.

The PEPP is intended to remain in place until at least the end of 2020. The ECB declared it will terminate this program only when the Governing Council judges that the COVID-19 crisis phase is over.

The PEPP will include all the asset categories eligible under the existing Expanded Asset Purchase Program ("EAPP", further described below), which include investment grade corporate debt instruments.

In addition, the range of eligible assets will be expanded to include all commercial paper of "sufficient credit quality." This measure is intended to encourage and support the banking sector's effort to finance businesses affected by the Covid-19 crisis.

François Villeroy de Galhau, the Governor of the *Banque de France*, specified in an interview published on 25 March 2020 that all commercial paper with a minimum remaining maturity of 1 month will now be eligible for purchase (whereas only marketable debt instruments with a minimum remaining maturity of 6 months are eligible for purchase under the EAPP).

D. Background – Previous Asset Purchase Programs

Financial Crisis

The first asset purchase program was launched in July 2009, with the ECB announcing the purchase of EUR 60 billion of Euro-denominated covered bonds from euro area banks by June 2010.

Euro-zone Crisis

At the time of the signature of the first Economic Adjustment Program for Greece in May 2010, the ECB launched the Securities Markets Program ("SMP"). It allowed the ESCB to "*conduct interventions in the euro area public and private debt securities markets […] to ensure depth and liquidity in those market segments which [were] dysfunctional.*"[5] At its peak, the SMP portfolio amounted to EUR 210 billion.

Upon termination of the SMP, previous ECB Chairman Mario Draghi announced the establishment of the OMT on 26 July 2012, giving assurances that the ECB was ready to do "*whatever it takes*" to preserve the Euro. This program was intended to allow the ESCB to purchase, on secondary markets, sovereign bonds issued by countries complying with the conditions attached to a European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) program to which they were subject.

The Expanded Asset Purchase Program (EAPP)

In January 2015, the ECB launched the EAPP to support investment and spending in a context of low growth. This program initially covered asset backed securities, covered bonds and public sector securities. It was extended to the corporate sector in June 2016.

The ECB conducted net purchases of securities under this program until December 2018. Between January

[5] ECB press release, 10 May 2010, "ECB decides on measures to address severe tensions in financial markets"

and October 2019, the ECB aimed to maintain the size of its cumulative net purchases under each constituent program of the EAPP at their respective levels as at the end of December 2018. In November 2019, the ECB announced that net purchases would be restarted at a monthly pace of EUR 20 billion per month. This program is still ongoing.

II. Supervisory and Capital Relief Measures

A. ECB / EBA

Stress Tests

The EBA has announced its decision to postpone the 2020 stress tests to 2021, and has stated that, for 2020, it will only carry out an additional EU-wide transparency exercise with the aim of ensuring the availability of updated information on banks' exposures and asset quality.

Inspections and Investigations

The ECB announced that individual initiatives will be discussed and agreed upon on a case-by-case basis, aimed at alleviating the supervisory burdens on banks' operations to the maximum extent possible.

In particular, while confirming that all decisions already adopted remain fully valid, the ECB has announced its decision to:

(i) extend by 6 months existing deadlines for remedial actions imposed as a result of on-site inspections, investigations related to internal models and targeted review of internal models (TRIM);

(ii) postpone by six months the issuance of TRIM decisions, on-site follow-up letters, and internal model decisions not yet communicated to banks (unless any such decision is explicitly requested by a bank);

(iii) postpone by 6 months the verification of compliance with qualitative supervisory review and evaluation process (SREP) measures;

Banks will be contacted by joint supervisory teams (JSTs), to further discuss the revised supervisory timelines and relevant impact on each supervised institution, bearing in mind that the latter have been encouraged to use enhanced flexibility while exercising their supervisory functions during the upcoming distressed period, potentially even outside the specific areas and tasks mentioned above.

Additional extensions will be assessed on the basis of future developments.

Capital Relief

On 12 March 2020, the ECB announced that, in order to face potential stress during the COVID-19 crisis, banks under its supervision (i.e. significant Eurozone credit institutions) will be allowed to temporarily (i.e. until further notice) operate below their Pillar 2 guidance (P2G) level and the requirements set forth under the capital conservation buffer (CCB) and liquidity coverage ratio (LCR) rules, as well as to partially use non-CET1 instruments (i.e. AT1 or T2 instruments) to meet their Pillar 2 requirements (P2R), thereby frontloading CRDV rules. [6]

On 20 March 2020, the ECB specified the following.

(i) With respect to *supervisory actions*, banks that operate below P2G and partially use AT1/T2 for purposes of P2R will not be subject to any supervisory action. By contrast, it appears that banks that elect to operate below CCB and LCR requirements may still be subject to supervisory action, including the requirement to produce a capital restoration plan.

(ii) With respect to *capital and liquidity restoration plans*, the ECB will "take a flexible approach" in evaluating and approving restoration plans

[6] In particular, paragraph 4 of art. 104a of CRD V provides that (a) at least three quarters of P2 requirements shall be met with T-1 capital, and (b) at least three quarters of the T-1 capital referred to in point (a) shall be composed of CET-1 capital.

that banks are required to submit when breaching capital and liquidity requirements.

(ii) As to *distributions*, banks operating below their combined buffer requirements will be able to make distributions within the limits of the maximum distributable amount (MDA) set forth under applicable rules, which continues to apply.

While confirming that it has no discretion to waive the application of the automatic restrictions on distributions provided for under applicable rules, the ECB expects some relief will come from its decision to allow banks to partially use non-CET1 instruments to meet P2R, since this will help reduce the MDA trigger level.[7]

The ECB also indicated that:

(i) while banks are not required to suspend or reduce distributions or buy-backs, it expects banks to adopt a prudent approach in light of the deteriorating economic outlook; and

(ii) the capital relief needs to be used to finance the economy and absorb losses (as opposed to distributions and variable remuneration).

Treatment of Exposures Towards Clients Facing Payment Challenges

The ECB indicated that it will use a flexible approach as regards the assessment and treatment of non-performing and forborne exposures by banks, as permitted under applicable rules and further detailed in the ECB-issued qualitative and quantitative guidance on non-performing loans ("NPL").

The ECB also provided practical examples of how this flexibility would work in connection with exposures benefiting from government guarantees or subject to payment deferrals.

With respect to exposures benefiting from *government guarantees*:

(i) The ECB will exercise the flexibility embedded in applicable rules (including its Guidance on NPL) as regards the classification of obligors as "unlikely-to-pay" upon the enforcement of the relevant public guarantees by banks. It therefore appears that calling on a public guarantee would not *per se* trigger the classification of the exposure as "unlikely-to-pay".

(ii) Banks will face a 0% minimum coverage expectation for the first 7 years after classifying any such exposure as non-performing, meaning that the ECB will extend to exposures benefiting from a public guarantee the preferential treatment afforded to NPL guaranteed or insured by export credit agencies.

As to *payment deferrals*, banks will be granted flexibility when classifying exposures subject to payment deferrals resulting from the COVID-19 crisis as "unlikely-to-pay", and should take into account public support measures in their assessment.

NPL Reduction Targets

As regards NPL reduction targets, the ECB announced that JSTs will exercise flexibility in evaluating banks' NPL reduction strategies, acknowledging that current market conditions may make current targets difficult to achieve.

Exposure Classification and Provisioning under IFRS9

The ECB acknowledged that its powers in connection with the interpretation and implementation of IFRS9 are limited, as accounting standards and their implementation are outside the remit of its banking supervision powers.

However, considering that IFRS9 provisioning is to a large extent also based on macroeconomic forecasting that may lend itself to potentially excessive pro-cyclicality, the ECB recommended that:

[7] The MDA is calculated as the amount of interim and/or year-end profits not yet incorporated in CET1 capital, multiplied by a factor ranging from 0 to 0.6 depending on the size of the CET1 shortfall against the combined buffer (see Article 141(4)(5)(6) of CRD V).

(i) All institutions not having already done so, adopt the transitional IFRS 9 arrangements set forth under art. 473(a) of CRR (allowing institutions to include in CET1 part of the amount corresponding to the transition to the new accounting standard, with a 5-year phasing out period), committing to timely review all applications;

(ii) When estimating long-term expected credit losses for IFRS9 purposes, considering the current uncertainty in creating reasonable and supportable forecasts, banks give greater weight to long-term stable outlook, as evidenced by past experience. In doing so, banks are encouraged to take into account the public relief measures granted by national authorities in connection with the COVID-19 epidemic.

The ECB also announced that – in order to help banks in their IFRS 9 provisioning policies – it will provide central macroeconomic scenarios. While these scenarios will likely not be binding on banks, it is reasonable to believe that the ECB will expect banks (if not to adopt them) at least consider them and explain departures therefrom.

Furthermore, on 25 March 2020, the EBA, in coordination with the ESMA, confirmed that:

(i) banks are not required to automatically classify payment deferrals as forbearance measures for the purposes of IFRS9 and the prudential definition of default in CRR, where such deferrals are not borrower-specific (*i.e.* where "*the length of the delays in payments is fixed for every borrower irrespective of the borrowers' specific financial circumstances*"). This principle will apply to statutory payment deferrals as well as payment deferrals resulting from private initiatives (e.g., by trade associations), subject to more specific criteria to be provided by the EBA; and

(ii) payment deferrals should be taken into account for the purposes of assessing the 90 days past due parameter for purposes of exposure classification; in other terms, the past-due assessment should be made on the basis of the new payment schedule (as amended by the deferral), absent specific circumstances.

B. France

On 13 March 2020 the *Banque de France* announced its decision to propose a complete relaxation (from 0.5% to 0) of the current countercyclical buffer, maintaining that this has been built up by French banks precisely to face emergency situations like the COVID-19 crisis.

The ACPR has to date not announced any supervisory or capital relief measures in favor of French banks and financial firms not supervised by the ECB.

C. Italy

On 20 March 2020, the Bank of Italy announced temporary relief measures to mitigate the impact of COVID-19 on the Italian banking and financial system.

Deadline Extensions

(1) 60 days for the obligations notably concerning: ICAAP/ILAAP for banks and securities investment firms (SIMs), and ICAAP for non-bank financial intermediaries (FIs) pursuant to Article 106 of the Consolidated Law on Banking (TUB); recovery plans, reports on outsourcing for banks and FIs; reports on organizational structures for SIMs, SGRs, SICAFs, SICAVs, PIs and EMIs (where required for significant organizational changes); depositories self-assessment of compliance with authorization requirements; anti-money laundering annual report (which includes the risk self-assessment for 2019); customer due diligence (recovery of customer data already obtained for anti-money laundering purposes); and report on compliance with the obligations regarding deposits and sub-deposits by customers by intermediaries that provide investment services;

(2) 150 days for submission of the first Report on Operational Risks and Safety for banks;

(3) 60 days for responses on consultations in progress on regulatory changes.

The deadline for transmitting the update to the non-performing loan reduction plan by less significant banks required to prepare such a plan has been postponed to 30 June 2020.

Capital Relief

By taking advantage of the flexibility already allowed under the regulations and in line with the decision of the ECB for significant banks, less significant banks and non-bank intermediaries are allowed to operate temporarily below the level of the Pillar 2 Guidance (P2G), the capital conservation buffer (CCB) and the liquidity coverage ratio (LCR).

Should these circumstances occur, the Bank of Italy will assess the restoration plans that intermediaries will submit, taking into account the exceptional circumstances that have caused the capital and liquidity buffers to fall below the required levels.

Inspections

The Bank of Italy has announced that it is (i) in the process of rescheduling on-site inspections and (ii) evaluating whether to allow some flexibility regarding the deadlines for supervisory reporting, in coordination with the EU authorities.

Business Continuity Plans

The Bank of Italy indicates that it is critical that banks' emergency plans consider and address the risk of a pandemic. Less significant banks and other supervised intermediaries are called upon to review their business continuity plans and to consider what action can be taken to minimize the potential adverse effects of the spread of COVID- 19.

D. Germany

On 24 March 2020, BaFin announced that it would adapt its supervisory practice and measures to the COVID-19 crisis by using supervisory flexibility under existing rules, without sacrificing financial stability.

By way of example, and in line with the ECB's indications, a debtor will not necessarily be classified as defaulting if loan servicing and interest are deferred as a result of the COVID-19 crisis.

With respect to *distributions*, BaFin recommends that banks refrain from buying back shares and carefully weigh dividends, profits and bonuses.

With respect to *IFRS9*, in line with ECB indications, BaFin recommends that banks "strengthen their medium-term view", adopt a "through the cycle" perspective and take into account public support measures.

III. Resolution and State Aid Relief in Favor of the Banking Sector

A. Commission

On 19 March 2020, the Commission adopted a communication setting out a temporary framework for the implementation of less stringent State aid rules in order to support the economy in the context of the COVID-19 crisis (the "Temporary Framework").[8]

Obligation to pass on the aid to final beneficiaries

Under the Temporary Framework, Member States can provide support measures to businesses facing sudden liquidity shortages in the form of public guarantees and subsidized interest rates under Article 107(3)(b) of the Treaty. This support can be provided by Member States either directly or through banks or other financial institutions.

In order for the aid to qualify as aid to the final beneficiaries (and not as an indirect advantage in favor of the financial institutions), financial institutions should:

(i) be able to demonstrate that they operate a mechanism that ensures that the advantages are

[8] See our full alert memorandum on the Temporary Framework: https://www.clearygottlieb.com/news-and-insights/publication-listing/state-aid-temporary-framework-to-support-the-economy-in-the-context-of-the-covid-19-outbreak

passed on to the largest extent possible to the final beneficiaries in the form of higher volumes of financing, riskier portfolios, lower collateral requirements, lower guarantee premiums or lower interest rates;

(ii) when there is a legal obligation to extend the maturity of existing loans for SMEs, not charge any guarantee fee.

Resolution and Burden Sharing Impacts

Under BRRD and SRMR, the granting of "extraordinary public financial support" to a credit institution automatically triggers placement in resolution, unless the conditions for a so-called "precautionary recapitalization" (or other exceptions) are met.

The Commission has clarified that aid granted to banks that is passed on to final beneficiaries is not designed to "preserve or restore the viability, liquidity or solvency" of the bank and should therefore not (i) be qualified as extraordinary public financial support for purposes of BRRD or SRMR and (ii) be assessed under the State aid rules applicable to the banking sector. This entails that this type of aid will not trigger (i) placement in resolution of the banks receiving the aid or (ii) burden-sharing with respect to CET1, AT1 or T2 instruments.

However, if due to the COVID-19 crisis, banks require direct support in the form of recapitalisations or impaired asset measures, these measures could trigger placement in resolution unless the bank satisfies the conditions to benefit from a precautionary recapitalization (or other exceptions).

Assuming these conditions are satisfied, aid addressing issues linked to the COVID-19 outbreak will benefit from the "financial stability" exception to burden-sharing requirements set forth in Article 45 of the Commission's 2013 communication.

B. SRB

As opposed to other EU banking authorities, the SRB has to date not announced relief measures with respect to MREL requirements, or deadline extensions with respect to resolution reporting documents due 31 March and 30 April 2020.

…

CLEARY GOTTLIEB