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ALERT MEMORANDUM

CRR Quick Fix to Facilitate Lending in Response to COVID-19 Adopted

July 02, 2020

On June 24, 2020, the EU Council announced that it had adopted Regulation EU 2020/873 ("CRR Quick Fix") amending Regulations (EU) No 575/2013, as amended ("CRR") and (EU) 2019/876 ("CRR2").[1] The new Regulation is based on the Commission's legislative proposal for a Regulation of April 28, 2020 ("Legislative Proposal")[2] which was amended in the co-legislation process. On June 26, 2020 the CRR Quick Fix was published in the Official Journal of the EU and entered into effect on June 27, 2020.[3] The CRR Quick Fix contains a number of adjustments to CRR and CRR II to facilitate lending by banks as a response to the COVID-19 crisis. The adjustments also reflect recent statements of the Basel Committee on Banking Supervision ("BCBS") addressing the challenges of the pandemic.

The Amendments to CRR based on the Commission's initial proposal

1. **Resetting the IFRS 9 transitional arrangements to mitigate the impact on regulatory capital and on banks' lending capacity of the likely increases in expected credit loss ("ECL") provisioning under IFRS 9 due to the economic consequences of the COVID-19 crisis**. The CRR Quick Fix amends Article 473a CRR which contains arrangements allowing institutions to add back to their Common Equity Tier 1 ("CET1") capital a portion of any increase in provisions due to the introduction of ECL accounting under IFRS 9 during a transitional period. The CRR Quick Fix introduces a new transition period that allows financial institutions to add-back increases in ECL provisions for non-credit-impaired assets to CET1 capital during 2020-2024.

   The key aspects of the changes are as follows:

   (i) The reference date for any increase in ECL provisions (the so-called "dynamic component") is moved to January 1, 2020 in order to limit the granted relief to COVID-19 related increases.

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[1] The CRR Quick Fix is available at http://data.europa.eu/eli/reg/2020/873/oj

[2] The Legislative Proposal is available at https://ec.europa.eu/finance/docs/law/200428-banking-package-proposal_en.pdf. For further details see our alert memorandum "The EU Commission adopts banking package to facilitate lending in response to COVID-19" published May 1, 2020, available at https://www.clearygottlieb.com/-/media/files/alert-memos-2020/the-eu-commission-adopts-banking-package-to-facilitate-lending-in-response-to-covid19-pdf.pdf.

[3] It also generally applies from June 27, 2020, except for the provisions relating to the leverage ratio offsetting mechanism.

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(ii) The revised text of Article 473a(1) CRR contains an adjusted formula for the calculation of the ECL amounts that can be added back to CET1 capital, which applies different factors to the "static component" relating to the "day-one impact" of IFRS 9 on CET1, which is not impacted by the changes, and the dynamic (post-day-one) component, which is subject to the extended transitional period and to revised transitional adjustment factors. Compared to the Legislative Proposal, the CRR Quick Fix has further adjusted the formula in Article 473a(1) CRR for the calculation of the ECL amounts that can be added back to CET1 capital.

(iii) A new Article 473a(6a) CRR resets and extends the transitional period for the dynamic component, allowing institutions to add back to their CET1 capital 100% of new ECL provisions recognised in 2020 (as opposed to 70% under the current rules) and 2021 (as opposed to 50% under the current rules) for their financial assets that are not credit-impaired. The percentage amount that could be added back from 2022 to 2024 would then decrease in a linear manner, and the transitional arrangement would be completely phased out starting from 2025. Accordingly, for relevant provisions raised from January 1, 2020, the CET1 add-back percentages are:

2020	100%
2021	100%
2022	75%
2023	50%
2024	25%

(iv) A new Article 473a(7a) CRR replaces the rescaling of all exposure values that are reduced by ECL provisions with a standard risk weight of 100% to be assigned to the amounts added back to CET1 capital. The standard risk weight of 100% is not mandatory (as in the Legislative Proposal) and institutions may choose (only once) to apply, instead, the scaling factor pursuant to Article 473a(7)(b) CRR.

(v) Institutions that opted previously not to use the transitional arrangements are allowed to opt in at any time during the transitional period (and to opt out again) subject to prior approval from their competent authority under the revised Article 473a(9). Institutions also have the option to apply only the dynamic component of the transitional arrangements, in which case they will have to inform their competent authority. The CRR Quick Fix also introduces a requirement for institutions to publicly disclose their decisions to opt in or opt out to the transitional arrangements (as well as any decision not to apply the dynamic component or to apply the scaling factor instead of the standardised 100% risk weight under Article 473a(7a)) or reverse their previous opt-out decisions with the prior permission of their competent authority.

2. **Preferential treatment for non-performing exposures ("NPEs") guaranteed or counter guaranteed by the public sector**. The preferential treatment granted under the CRR's prudential backstop[4] is extended to NPEs guaranteed or insured by an export credit agency to NPEs that benefit from guarantees or counter-guarantees granted by national governments or other public entities. While the Legislative Proposal proposed limiting the preferential treatment to a period of seven years, this limitation is not part of the CRR Quick Fix. In addition, the Legislative Proposal that expressly limited the preferential

[4] Article 47c(4) CRR.

treatment to measures taken in response to the COVID 19 pandemic was also not incorporated in the final Regulation.

3. **One--year delay of application of the Global Systemically Important Institution ("G-SII") leverage ratio buffer introduced by CRR2**.[5] Following the CRR Quick Fix, the application date for the buffer is now set to January 1, 2023, as proposed by the Legislative Proposal.[6] This is in line with the measures recently endorsed by the BCBS' Governors and Heads of Supervision.[7] Until the requirement applies, there would be no consequences for the failure to meet the leverage ratio buffer requirement as set out in Article 141c of Directive 2013/36/EU, as amended ("CRD"), and no related restrictions on distributions set out in Article 141b CRD would apply.

4. **Adjustment to the leverage ratio mechanism for offsetting the impact of using the discretion to temporarily exclude certain central bank exposures from total exposure measure**. Pursuant to Article 429a CRR (as introduced by CRR2), institutions have the discretion to exclude certain central bank exposures from their total exposures' calculation, if the institution's competent authority has determined, after consultation with the relevant central bank, and publicly declared that exceptional circumstances exist that warrant the exclusion in order to facilitate the implementation of monetary policies. Any impact of the discretion is subject to an offsetting mechanism that increases the individual leverage ratio in a proportionate manner. In line with the Legislative Proposal, the CRR Quick Fix modifies the offsetting mechanism to avoid banks being discouraged from drawing on central bank liquidity facilities. An institution that exercises the discretion will be required to calculate the adjusted leverage ratio only once (at the moment it exercises the discretion), and based on the daily average total value (calculated over the full reserve maintenance period of the central bank immediately preceding the date when the institution's competent authority declares that exceptional circumstances that warrant the exercise of the discretion exist) of the institution's eligible central bank reserves and total exposure measure on the declaration date. The modification will also allow the exclusion of all eligible central bank reserves, rather than just those entered into after the exemption took effect.

   The revised mechanism will apply from June 28, 2021. However, beyond the Legislative Proposal the CRR Quick Fix also adds new temporary measures to the CRR regarding the calculation of the leverage ratio which will apply until June 27, 2021.[8]

5. **One-year acceleration of the ability not to deduct "prudently valued software" from CET1 capital under CRR2**.[9] In accordance with the Legislative Proposal, the CRR Quick Fix amends CRR2 to allow the exemption from the deduction to apply from the entry into force of regulatory technical standards ("RTS") to be drafted by the European Banking Authority ("EBA") concerning the criteria and modalities for such deduction.[10]

6. **Acceleration of the application of the favourable treatment for certain loans backed by pensions or salaries under CRR2**.[11] As was proposed, CRR2 is amended to permit the favourable treatment of such loans to apply starting from June 27, 2020.

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[5] Article 92(1a) CRR.
[6] New Article 3(5) CRR2.
[7] *See* press release of March 27, 2020 "*Governors and Heads of Supervision announce deferral of Basel III implementation to increase operational capacity of banks and supervisors to respond to COVID-19*", available at: https://www.bis.org/press/p200327.htm.
[8] New Articles 500b and 500d CRR as discussed below.
[9] New Article 3(7) CRR2 with respect to Article 36(1) CRR.
[10] The EBA launched a consultation on the draft RTS on June 09, 2020, which is available at https://eba.europa.eu/eba-launches-consultation-technical-standards-specifying-prudential-treatment-software-assets.
[11] New Article 3(3a)(a) CRR2 with respect to Article 123 CRR.

7. **Acceleration of the application date of the revised SME supporting factor and the infrastructure supporting factor under CRR2, allowing a more favourable treatment of certain exposures to SMEs and infrastructure with a view to incentivise institutions to prudently increase lending to those entities**.[12] The revised factors will also start to apply from June 27, 2020.

Measures introduced during the co-legislation process

1. **Report on overshootings and supervisory powers to limit distributions**.[13] The CRR Quick Fix requires the Commission to report to the Parliament and to the Council by December 31, 2021 on whether a serious economic disturbance in the orderly functioning and integrity of financial markets justifies (i) permitting competent authorities to exclude from institutions' market risk internal models overshootings that do not result from deficiencies in those models, and (ii) granting competent authorities binding powers to impose restrictions on distributions by firms.

   Crucially, the co-legislators did not adopt measures discussed in the legislation process to impose mandatory Additional Tier 1 ("AT1") coupon restrictions for institutions that benefit from relief and capital conservation measures and to give new powers to regulators to apply temporary suspensions of distributions to holders of AT1 coupons. These proposed amendments were tabled in the second draft report on the Legislative Proposal of the Rapporteur of the European Parliament's Committee on Economic & Monetary Affairs ("ECON"), published on May 27, 2020[14]. However, after the ECON members voted on the proposed amendments they were not included in the final report that was tabled for the parliamentary plenary on June 10, 2020[15] and that was finally voted on in the plenary on June 18, 2020. It appears that some MEP factions greatly opposed the proposed measures and that, during ECON's discussions, the Council already signaled that it would not endorse such amendments.[16]

2. **Exclusion of overshootings from the calculation of the back-testing addend in view of the COVID-19 pandemic**.[17] Between January 1, 2020 and December 31, 2021, competent authorities may derogate from Article 366(3) CRR and exclude overshootings that occurred in the firms' back-testing as long as such overshootings do not result from deficiencies in their internal models. This enables the authorities to mitigate the effects of the COVID-19 pandemic in the firms' internal models and to prevent additional multipliers being applied to the firm's own funds requirements for market risks as a consequence of these overshootings. As discussed above, the CRR Quick Fix also requires the Commission to report on whether this measure should be made generally available to authorities in future crisis.

3. **Temporary treatment of public debt issued in the currency of another Member State**.[18] The CRR Quick Fix provides a transitional arrangement that allows a temporary preferential treatment of exposures to central governments and central banks of Member States, where those exposures are denominated and funded in the domestic currency of another Member State. This treatment applies until December 31, 2024 in respect of the risk weights provisions[19] and until December 31, 2025 under the large exposure regime.[20]

[12] New Article 3(3a)(b) and (c) CRR2 with respect to Articles 501 and 501a CRR.
[13] New Article 518b CRR.
[14] Available at https://www.europarl.europa.eu/doceo/document/ECON-AM-652494_EN.pdf
[15] Available at https://www.europarl.europa.eu/doceo/document/A-9-2020-0113_EN.pdf
[16] *See* article by MEP Sven Giegold is available at https://sven-giegold.de/en/wrong-answer-to-the-crisis/
[17] New Article 500c CRR.
[18] New Article 500a CRR.
[19] Article 114 CRR.
[20] Articles 395 and 493 CRR.

4. **Temporary measures relating to the calculation of the leverage ratio**.[21] Under new temporary measures derogations from Article 429(4) CRR are permitted until June 27, 2021. Until then an institution may (i) exclude certain exposures to central banks from the total exposure measure if the competent authority has determined, in conjunction with the relevant central bank, and declared that exceptional circumstances exist that warrant the exclusion;[22] and (ii) apply a revised calculation for the exposure value of regular-way purchases and sales awaiting settlement.[23]
5. **Temporary treatment of unrealised gains and losses measured at fair value through other comprehensive income in view of the COVID-19 pandemic ("prudential filter for sovereign bonds")**.[24] From January 1, 2020 to December 31, 2022, institutions can derogate from Article 35 CRR and remove from the calculation of their CET1 items unrealised gains and losses on their assets or liabilities measured at fair value corresponding to exposures to central governments, to regional governments, to local authorities, and to public sector entities. The amount is calculated by a specified formula. The effect of this temporary prudential filter is that firms can add back a certain percentage of deductions to CET1 capital. As a consequence, the impact of the pandemic on firms' regulatory capital is reduced strengthening their ability to lend money to clients. For the period from January 1, 2020 to December 31, 2020, firms can add back 100% of unrealised gains and losses on the holding of sovereign bonds. The percentage amount that can be added back in the following periods decreases in a linear manner.

Brexit and the CRR Quick Fix

The UK Government and the Prudential Regulation Authority ("PRA") have expressed broad support for the CRR Quick Fix, in particular the revised IFRS 9 transitional arrangements.[25] The PRA intends that, subject to the need for sufficient resilience at the end of the transitional period, all aspects of supervision of a firm using the transitional arrangements would be carried out using 'transitional' data on capital resources and not 'fully loaded' figures. In particular, as stress tests should reflect how stress would be experienced, those tests should fully take account of the revised transitional arrangements. As a practical matter, firms currently applying the transitional arrangements that are considering ceasing to apply them should note that, under the CRR, doing so would require the PRA's permission. If a firm wishes to apply for PRA permission no longer to apply the transitional arrangements, it should contact its PRA supervisor with a request by Friday July 31, 2020 and include a written explanation of the basis on which its management body has satisfied itself of the continuing adequacy of the firm's financial resources, including in stressed scenarios. Its supervisor will discuss the matter with it in the context of supervision of the firm's resilience and capital adequacy.

However, the government articulated some concerns with the prudential filter for sovereign bonds and its impact on minimum capital requirements but indicated that the PRA could address any concerns under Pillar 2. Similarly, the government acknowledges doubts raised by the Deputy Governor for Prudential Regulation in relation to the prudence of ending capital deductions for certain software assets but states that these doubts can be addressed under Pillar 2. The PRA intends to request data to facilitate quantitative analysis of the impact of these measures as well as the measures relating to the application of the revised SME support

[21] New Articles 500b and 500d CRR.
[22] New Article 500b CRR.
[23] New Article 500d CRR.
[24] New Article 468 CRR.
[25] *See* the letter of June 25, 2020 sent by the Economic Secretary to the Treasury, available at http://europeanmemoranda.cabinetoffice.gov.uk/files/2020/06/20200624_EST_to_EoK_-_Covid-19_banking_package.pdf and "Statement by the PRA on the CRR 'Quick Fix' package", available at https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/2020/statement-on-crr-quick-fix.pdf

factor and the infrastructure support factor. Analysis of this data will inform the PRA's supervisory approach including an assessment of whether further action is necessary under Pillar 2.

The CRR Quick Fix will be on-shored into UK law under the European Union Withdrawal Act 2018 (the "Withdrawal Act"). However, where it makes changes to the date of application of a CRR provision and the new date is beyond the end of the Brexit transition (currently December 31, 2020), the CRR provision will not be on-shored under the Withdrawal Act. This applies to the revised leverage ratio offsetting mechanism that will apply from June 28, 2021 in the EU. Also, the delayed application of the G-SII leverage ratio buffer will not automatically apply in the UK. However, it's hard to see the UK not adopting these changes (among other things, HM Treasury and the Prudential Regulation Authority have already welcomed the international agreement to delay the G-SII leverage ratio buffer and other elements of the final Basel III standards).

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