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ALERT MEMORANDUM

The EU Commission adopts banking package to facilitate lending in response to COVID-19

May 1, 2020

On April 28, 2020 the EU Commission issued a comprehensive banking package consisting of:

1. **a legislative proposal** for a Regulation amending Regulation (EU) No 575/2013, as amended ("CRR") to make a number of "quick-fix" targeted adjustments to address specific needs arising from the COVID-19 crisis. The Commission optimistically expects that the proposed Regulation could be adopted by the Parliament and the Council as early as June 2020; and
2. **an Interpretative Communication** which sets out a number of recommendations for banks and supervisory authorities confirming and further clarifying the guidance already provided to credit institutions by the Commission itself, the European Central Bank ("ECB"), the European Banking Authority ("EBA"), the European Securities and Markets Authority, the Committee of European Audit Oversight Bodies, the Basel Committee on Banking Supervision ("BCBS") and other authorities on making full use of the flexibility embedded in certain EU accounting and prudential rules.

(1) Legislative proposal for a regulation amending CRR[1]

A. **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**. In line with the recent BCBS guidance,[2] the new transition period will allow financial institutions to add-back increases in ECL provisions for non-credit-impaired assets to their Common Equity Tier 1 ("CET1") capital during 2020-2024.[3] This would alleviate the impact of the COVID-19 pandemic on institutions' possible increases in provisions under IFRS 9, while maintaining the transitional arrangements for the ECL amounts established before the pandemic.

In particular:

(i) Under the proposed Regulation, the reference date for any increase in ECL provisions (the so-called "dynamic component") that would be subject to the extended transitional arrangements is set to January 1, 2020, as any such increase from this date would likely be related to COVID-19.

[1] The legislative proposal is available at https://ec.europa.eu/finance/docs/law/200428-banking-package-proposal_en.pdf
[2] See "*Measures to reflect the impact of COVID-19*," published by the BCBS on April 3, 2020, available at https://www.bis.org/bcbs/publ/d498.pdf
[3] See the proposed amendments to Article 473a CRR.

(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 proposed changes, and the dynamic (post-day-one) component, which will be subject to the extended transitional period and to revised transitional adjustment factors.

(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.

(iv) The proposed changes to Article 473a(7) CRR replace 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.

(v) Institutions that opted previously not to use the transitional arrangements are allowed to opt in at any time during the transitional period subject to prior approval from their competent authority under the revised Article 473a(9). In its press release of March 20, 2020 and its letter to banks of April 1, 2020,[4] the ECB had already recommended that all institutions supervised by it opt to apply the transitional provisions. Institutions will also have the option to apply only the dynamic component of the transitional arrangements (impacted by the extension at hand), in which case they will have to inform their competent authority.

B. **7-year preferential treatment for non-performing exposures ("<u>NPEs</u>") guaranteed or counter-guaranteed by the public sector pursuant to measures adopted by EU Member States to mitigate the economic impact of COVID-19, for purposes of the rules on the minimum loss coverage for NPEs (subject to compliance with applicable state aid rules).**[5] This would apply the same treatment to such NPEs as is applied to NPEs which are guaranteed or insured by an official export credit agency.[6] The measure mirrors the extension made by the ECB for purposes of its Guidance on NPLs[7] and recognizes the comparable risk mitigation effects shared by official export credit agencies guarantees and COVID-19-related guarantees.

C. **1-year delay of application of the Global Systemically Important Institution ("<u>G-SII</u>") leverage ratio buffer introduced by Regulation (EU) 2019/876 ("<u>CRR2</u>").[8]** The requirement will now apply from January 1, 2023.[9] This is in line with the measures recently endorsed by the BCBS' Governors and Heads of Supervision[10]. It is designed to free up credit institutions' operational capacity and allow them to focus on the more immediate challenges associated with the COVID-19

[4] See the ECB letter to significant institutions of April 1, 2020, available at: https://www.bankingsupervision.europa.eu/press/letterstobanks/shared/pdf/2020/ssm.2020_letter_IFRS_9_in_the_context_of_the_coronavirus_COVID-19_pandemic.en.pdf

[5] See the proposed new Article 500a CRR providing for a derogation from Article 47(c)(3) CRR.

[6] Article 47c(4) CRR.

[7] See Section 1 of the "*FAQs on ECB supervisory measures in reaction to the coronavirus*", available at https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200320_FAQs~a4ac38e3ef.en.html.

[8] Article 92(1a) CRR

[9] See the proposed amendment to Article 3(5) CRR2.

[10] 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. In the Interpretative Communication, the Commission confirmed that it plans to postpone the adoption of its legislative proposal on the final elements of the Basel III framework, but to still adopt in time for the outstanding Basel III standards to be effectively implemented in the EU by January 2023.

pandemic. 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.

D. **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**.[11] Pursuant to Article 429a CRR (as introduced by CRR2), credit institutions can request a temporary exclusion of certain central bank exposures from their total exposures' calculation, subject to approval by the relevant competent authority. The discretion is aimed at facilitating the effective transmission of monetary policy measures under exceptional circumstances, and any impact of the exclusion shall be offset by a mechanism increasing the individual leverage ratio in a strictly proportionate manner. As currently designed, however, the offset mechanism could actually discourage banks from drawing on central bank liquidity facilities, as they may face limitations on their central bank reserves' level. Therefore, in order to avoid excessive constraints on banks, the EU Commission has proposed to revise the offset mechanism. The revised mechanism would apply from June 28, 2021.

In particular:

(i) A credit 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 value of the institution's eligible central bank reserves and total exposure measure on the day when the institution's competent authority declares that exceptional circumstances that warrant the exercise of the discretion exist.

(ii) The modification would also allow the exclusion of all eligible central bank reserves, rather than just those entered into after the exemption took effect.

E. **1-year acceleration of the ability not to deduct "prudently valued software" from CET1 capital under CRR2.[12]** The deduction will be applicable from the entry into force of regulatory technical standards to be drafted by the EBA concerning the criteria and modalities for such deduction.[13] This measure responds to the accelerated up-take of digital services following certain public measures adopted to address the effects of the COVID-19 pandemic.

F. **Acceleration of the application of the favourable treatment for certain loans backed by pensions or salaries under CRR2**.[14] Such favourable treatment would apply starting from the day following the publication of the amending Regulation in the Official Journal of the EU. The measure is aimed at encouraging lending towards employees and pensioners, potentially severely affected by the COVID-19 crisis.

G. **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**.[15] The revised factors would apply starting from the day following the publication of the amending Regulation in the Official Journal. The measure would free up institutions' own funds, thereby allowing them to boost lending during the COVID-19 pandemic.

[11] See proposed amendments to Article 429a CRR.
[12] See proposed amendment to Article 3(7) CRR2 with respect to Article 36(1) CRR.
[13] These are due to be issued in Q2 or Q3 of this year.
[14] See proposed new Article 3(3a)(a) CRR2 with respect to Article 123 CRR.
[15] See proposed new Article 3(3a)(b) and (c) CRR2 with respect to Articles 501 and 501a CRR.

(2) Interpretative Communication [16]

A. General

(i) The Commission encourages banks to make full use of the flexibility that is embedded in the existing accounting and prudential rules to support the EU economy in the exceptional circumstances of the COVID-19 outbreak. The application of government economic support and relief measures, which are designed to bridge short-term liquidity needs, should not automatically lead to a harsher accounting or prudential treatment of the relevant credit exposures, where the financial situation does not otherwise deteriorate.

(ii) At the same time, it is crucial that banks continue to measure risks in an accurate, consistent and transparent manner. Banks must continue to identify situations where borrowers may face financial difficulties that could impact their capacity to repay their loan obligations in the longer term. Banks must also apply sound underwriting and customer due diligence standards.

B. IFRS 9

The ECL framework under IFRS 9 requires the application of **judgement and flexibility**. Under an exceptional situation such as the COVID-19 crisis, banks (as well as other companies) are not expected to mechanically apply their existing ECL approaches in order to determine the amount of required provisions.

In particular:

(i) Banks' assessment of a significant increase in credit risk ("SICR"), for the purposes of deciding whether a credit exposure should be moved to "Stage 2" provisioning, should be based on the remaining lifetime of the financial assets concerned. Sudden, punctual and temporary increases in the probability of default ("PD") caused by the COVID-19 crisis should not lead to a significant increase in the lifetime PD.

(ii) In assessing if a SICR has occurred, banks should give sufficient weight to scenarios based on long-term stable macro-economic outlooks, as recommended by the ECB.

(iii) It is unlikely that temporary relief measures related to the COVID-19 crisis, such as private or statutory *moratoria*, constitute substantial "modifications" under IFRS 9, which would lead to a de-recognition of the relevant exposure.

(iv) Loans should not automatically be considered to have suffered a SICR simply due to becoming subject to private or statutory moratoria.

(v) Loan guarantees neither increase nor reduce the default risk of the borrower; they reduce the amount of credit losses if a default of the borrower actually occurs. Consequently, banks should expect lower credit losses, as a portion of it would be compensated by the guarantees.

(vi) Banks should provide insightful disclosures on the determination of ECL under IFRS 9, including information on the downside scenarios. Banks should also disclose, in the notes, specific accounting policies adopted in relation to the COVID-19 crisis. Such disclosures would allow market participants to make informed assessments on the credit risk exposures of banks. External auditors are expected to take the Interpretative Communication into account in their audit work.

[16] The Interpretative Communication is available at: https://ec.europa.eu/finance/docs/law/200428-banking-package-communication_en.pdf

(vii) Banks are encouraged to implement the IFRS 9 transitional arrangements that will reduce the impact of IFRS 9 ECL provisioning on banks' regulatory capital (see above, on the proposed amendments to Article 473a CRR).

C. Non-performing loans, definition of default, forbearance

(i) The prudential rules on the classification of non-performing loans can accommodate relief measures such as guarantees and private or statutory moratoria.

(ii) The prudential rules do not require a bank to automatically consider an obligor in default when it calls on a guarantee. At the same time, a guarantee does not preclude that an obligor is classified as defaulted. Irrespective of the existence of a guarantee, the bank has to form an opinion as to whether the obligor is in a position to meet its obligations. When assessing a borrower's capabilities to meet its obligations, banks should take into account the long-term prospects of the borrower, paying attention to situations where temporary problems are most likely to transform into longer-term difficulties and eventually lead to insolvency.

(iii) The public and private moratoria schemes introduced in response to the COVID-19 crisis do not automatically lead to a reclassification of an exposure as "forborne", "performing" or "non-performing forborne". Such schemes have a predominantly preventive and general nature, as they aim to address systemic risks and alleviate potential negative consequences that may occur to the wider EU economy in the future. They are not borrower-specific.

(iv) Where the repayment of an obligation is suspended because of a moratorium, the counting of the "days past due" is suspended and any delays are counted based on the modified schedule of payments. While banks are still obliged to assess the obligor's unlikeliness to pay on a case-by-case basis, this assessment refers to the modified schedule of payments, and where there are no concerns in that regard the exposure may remain in performing status.

(v) Banks are expected to apply a risk-based approach to assess the credit risk of obligors benefitting from a payment moratorium. Even where payment moratoria are not classified as forbearance measures, banks have to carefully assess the credit quality of their exposures benefiting from these measures and identify any situations of unlikeness to pay of obligors for the purpose of the definition of default. Banks should pay particular attention and prioritise the assessment of those obligors, who are most likely to experience payment difficulties.

D. Role and responsibility of the banking sector

Finally, the EU Commission issued some additional comments concerning how banks should see their broader (social) responsibilities in the crisis. This may be helpful to banks in making the judgement calls required by the guidance.

(i) To be effective, the economic support and relief measures adopted by public authorities need effective transmission channels and the full collaboration of the banking sector. Banks are responsible for keeping liquidity flowing and should continue to assume their collective duty to preserve interbank lending. It is therefore crucial that banks continue to lend to households and businesses and across the EU.

(ii) Banks should accelerate the digital transformation of their businesses and remain vigilant with regard to fraud.

(iii) Banks, although substantially recapitalised and much better equipped to sustain adverse scenarios than during the financial crisis of 2008/9, need nonetheless to prepare for a worsening economic outlook that will inevitably increase the risks they face and related costs.

Banks have to act prudently to make sure they preserve or reinforce their capital base and implicitly their capacity to continue lending.

(iv) In the current exceptional situation, retention of dividends represents a prudent adjustment to banks' distribution policies. All banks in the EU are urged to refrain from making dividend distributions and carrying out share buy-backs aimed at remunerating shareholders during the period of the COVID-19 crisis. The banking sector would thus send a strong signal that it is collectively committed to play its part in dealing with the emergency. A recommendation to significant institutions within the SSM to refrain from dividend distributions and share buy-backs at least until October 1, 2020 was issued by the ECB on March 27, 2020[17] and followed by similar recommendations of national competent authorities.

(v) In the current circumstances, banks are also invited to adopt a conservative approach to the payment of variable remuneration. It is of paramount importance that all resources available to banks, including those allocated for bonuses, are, as much as possible, mobilised to reinforce banks' robustness, their lending capacity and so ultimately support their clients.

Brexit and the Commission's banking package

The proposed amending Regulation will be on-shored into UK law under the European Union (Withdrawal) Act 2018, except for the amendment to leverage ratio offsetting mechanism. 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 European Union Withdrawal Act. 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).

The Interpretative Communication is largely consistent with the statements issued so far by the UK authorities, but banks may need to closely compare the Communication with, in particular, the Dear CEO letter from the Bank of England's Deputy Governor for Prudential Regulation to banks on IFRS 9, capital requirements and loan covenants[18]. After the Brexit transition period, to the extent still relevant, the UK regulators will probably expect UK firms to continue following it unless they provide different guidance.

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[17] Available at: https://www.bankingsupervision.europa.eu/ecb/legal/pdf/oj_c_2020_102i_full_en_txt.pdf

[18] Available at: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2020/COVID-19-ifrs-9-capital-requirements-and-loan-covenants.pdf?la=en&hash=77F4E1D06F713D2104067EC6642FE95EF2935EBD