



Coronavirus response: Banking Package to facilitate bank lending- Supporting households and businesses in the EU

Brussels, 28 April 2020

INTRODUCTION

What is in today's banking package?

Today's package is intended to encourage banks to make full use of the flexibility embedded in the EU's prudential and accounting framework, so that banks can fully support citizens and companies during this pandemic by providing funding. It is part of a series of measures taken by the European Commission to mitigate the economic impact of the Coronavirus pandemic across the European Union.

Today we are clarifying how the current rules can be applied more flexibly and in a coherent manner across the EU, while maintaining a prudent approach so as to preserve financial stability. It provides a consistent and uniform interpretation of the flexibility in these rules, so that banks and supervisors are on the same footing across the EU. Today's package includes an Interpretative Communication on the EU's accounting and prudential frameworks ("Supporting businesses and households amid COVID-19"), as well as targeted "quick fix" amendments to EU banking rules (the Capital Requirements Regulation (CRR)).

What does the Interpretative Communication aim to do?

In its Communication of 13 March 2020 on a coordinated economic response to the Coronavirus pandemic, the Commission invited prudential and accounting authorities to further specify how to make best use of the flexibility provided for in the existing regulatory framework. These authorities have since provided guidance on how these rules should be applied in the EU.

Today's Interpretative Communication confirms this guidance and further clarifies how EU rules should be applied by banks and supervisors in a flexible but responsible manner, so that they can continue to lend to businesses and households in the current context. It is part of EU efforts to ensure a coordinated response to the pandemic in order to avoid national fragmentation and to ensure a level playing field.

How will the Commission work with the financial sector to ensure a coordinated response to mitigate the impact of the pandemic and contribute to economic recovery?

The Commission will launch a dialogue with the European financial sector and business and consumers representatives to explore ideas on how the sector should support efforts to help citizens and businesses through this pandemic and to enable a recovery. To this end, the Commission will work closely with all relevant stakeholders in the financial sector to support their role and engagement and to draw up a list of best practices.

INTERPRETATIVE COMMUNICATION ON "SUPPORTING BUSINESSES AND HOUSEHOLDS AMID COVID-19"

What are the recommendations in today's Interpretative Communication? Can you give examples of flexibility in the EU's banking rules?

Following the financial crisis, the EU's financial system is far more robust and banks are better capitalised. The creation of the Banking Union in 2013, with more coordinated supervision and efforts to reduce risk in the banking system has greatly helped in terms of making the financial sector more resilient.

This is why the banking sector is now in a position to use the flexibility provided by prudential and accounting rules. This exceptional situation caused by the Coronavirus pandemic means that some of the rules can be used more flexibly at this time so that banks can focus on lending to households and companies.

At the same time, it is crucial that banks continue to measure risks in an accurate, consistent and transparent manner, so they can monitor the effects of the Coronavirus pandemic on their balance sheets and safeguard the resilience of the European banking sector. This means that 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 equally continue to apply sound underwriting and know-your-customer standards as required by EU legislation. However, this exceptional situation caused by the Coronavirus pandemic means that some of the rules can be used more flexibly at this time so that banks can focus on lending to households and companies.

The areas of flexibility in the EU's regulatory framework include:

1. The rules on how banks assess the risk that a borrower will not repay a loan in a sudden economic crisis, such as the Coronavirus pandemic, and the effect that has on the amount of money the bank needs to set aside for any possible losses;
2. The prudential rules on the classification of non-performing loans in the context where relief measures such as guarantee schemes and moratoria have been provided either by Member States or by banks;
3. The accounting treatment of delays in the repayment of loans. The Interpretative Communication clarifies that the application of relief measures alone which banks or States grant households and businesses to bridge short-term liquidity needs, such as delays in the repayment of loans, should not automatically lead to a harsher accounting treatment of the respective loans.

Today's Communication confirms the guidance given by European authorities^[1] and international bodies^[2] regarding the flexibility in the EU's current accounting rules and prudential requirements. The Communication reinforces the EU's collective commitment towards the consistent and concerted application of these rules.

What is IFRS 9 and how can its flexibility help ensure liquidity flows during the Coronavirus pandemic?

IFRS 9 is an international accounting standard, which sets out, amongst other things, how companies should value financial assets (e.g. loans to households or companies) and how they should measure the risk associated with lending. It is of particular relevance to banks.

Today's Interpretative Communication clarifies the flexibility available in IFRS 9 and explains how that can maintain the flow of liquidity to EU households and businesses:

- **The Expected Credit Loss (ECL) approach under IFRS 9:** Today's Interpretative Communication states that the temporary inability of households or businesses to pay back their loans because of the Coronavirus pandemic should not mean that banks have to automatically significantly increase their so-called ECL provisions. Today's Communication confirms that the ECL approach under IFRS 9 leaves it to banks to use their own judgment when determining if expected credit losses are required to be recognised. As indicated by the IASB^[3] -- including references to statements made by ESMA, the EBA and the ECB-SSM - banks (and other companies) are not expected to mechanically apply their existing ECL approaches in an exceptional situation such as the Coronavirus pandemic. The Basel Committee on Banking Supervision has also provided clarifications on the treatment of extraordinary support measures and ECL provisioning on 3 April 2020 (<https://www.bis.org/press/p200403.htm>).
- **The Assessment of a "Significant Increase in Credit Risk" (SICR):** The assessment by a bank of a "Significant Increase in Credit Risk" (SICR) should be based on the remaining lifetime of a loan and not just on the sudden increase in the probability of default caused by the Coronavirus pandemic. In assessing if a SICR has occurred, banks should give sufficient weight to scenarios based on long-term stable macro-economic outlooks.
- **Use of moratoria and "Significant Increase in Credit Risk":** Loans should not automatically be considered to have suffered a "Significant Increase in Credit Risk" simply because they have become subject to private or statutory moratoria. Banks are invited to use quantitative and qualitative judgement and take into account the specific characteristics of the moratoria, to conclude whether loans subject to moratoria would have suffered a SICR.

What does today's Communication say about loans, mortgages and payment moratoria?

In order to help citizens and businesses overcome the disruption caused by the Coronavirus pandemic, Member States have introduced temporary measures which generally enable both individual and corporate borrowers to defer the repayment of their loans for a limited period of time (for example three or six months). This option is available for consumer and business loans, including mortgages. These moratoria [i.e. a suspension of repayments] represent an effective tool to address short-term liquidity difficulties caused by the limited or suspended operations of many businesses and individuals, resulting from the Coronavirus pandemic.

The Interpretative Communication clarifies the treatment of such moratoria in order to ensure a level playing field across the EU so that households, businesses, and banks benefit from a harmonised

application and enforcement of the rules. As mentioned above, individual or corporate loans that benefit from moratoria should not automatically be considered to have suffered a "Significant Increase in Credit Risk" simply because they have become subject to private or public moratoria.

The public and private moratoria schemes introduced in response to the Coronavirus pandemic have a predominantly preventive and general nature. As long as these schemes fulfil a number of conditions, they are not considered as forbearance measures and therefore do not affect the classification of the loans concerned. The applicable conditions are specified in the EBA guidelines of 2 April 2020 on payment moratoria, which are also intended to ensure that public and private moratoria are being treated similarly to the extent they have the same purpose and similar characteristics.

Non-performing loans: is there any flexibility in EU rules?

Non-Performing Loans (NPLs) are a legacy of the last financial crisis in Europe. While NPL stocks remain high in some Member States, it should be underlined that significant progress has been made in recent years, with banks strengthening their balance sheets, reducing the level of non-performing loans and improving operational efficiency. Asset quality has improved and the non-performing loans ratio has substantially declined.

Government guarantees and payment moratoria are key measures by banks and Member States to support borrowers that are affected by the pandemic. Concerns have been raised that prudential rules on the classification of NPLs (definition of default and loan forbearance under the Capital Requirement Regulation – CRR) may stand in the way of a widespread use of these measures. The Communication clarifies how the prudential rules on the classification of NPLs can accommodate these measures in line with the statements and guidance by the European Banking Authority and the European Central Bank.

What are the Commission's views on digital payments?

Today's Communication points to the opportunity for banks to accelerate the development of digital finance. The Commission encourages banks to promote digital banking, while at the same time, remaining alert and continuing to fight financial crime, which is likely to increase in the context of the pandemic.

On 2 April, the Commission launched consultations on a retail payment strategy and a new digital finance strategy for the EU^[4] in order to gather views on further developing European retail payments and digital finance so that citizens benefit from faster, cheaper and more efficient systems, while ensuring consumer protection.

LEGISLATIVE PROPOSALS

What legislative changes has the Commission proposed today?

The Commission has today proposed exceptional temporary measures in order to maximise the ability of EU banks to lend during the Coronavirus pandemic, while also ensuring their continued resilience.

The following set of targeted changes to Capital Requirements Regulation (Regulation (EU) 575/2013) have been proposed:

Basel III: Transitional arrangements for mitigating the impact of IFRS 9 provisions on regulatory capital

- The application of IFRS 9 during the Coronavirus pandemic may lead to a sudden significant increase in the Expected Credit Loss (ECL) provisions of banks, which would result in an erosion of their capital, and therefore their ability to continue lending at a time when businesses and households need it most. To mitigate the potential negative impact of this, the Commission has proposed an extension of the current transitional arrangements in the CRR by two years, in line with the international agreement of the Basel Committee. This would allow banks to add back to their regulatory capital any increase in new expected credit losses provisions that they recognise in 2020 and 2021 for their financial assets, which have not defaulted.
- To ensure that the additional relief is related to the exceptional circumstances of the Coronavirus pandemic, only provisions incurred as of 1 January 2020 would be eligible.

Basel III: Date of application of the leverage ratio buffer

- The last revision of the CRR introduced a leverage ratio buffer requirement on global systemically important institutions (G-SIIs). The date of application of this new leverage ratio buffer requirement was originally set for 1 January 2022. In the context of the Coronavirus pandemic and in line with the revised implementation timeline agreed by the Basel Committee, the date of application is proposed to be deferred by one year to 1 January 2023.
- We remain committed to implementing the final Basel III standards in the EU. We will use the

additional time to take into account the impact of the Coronavirus pandemic on banks' financial situation in the impact assessment that will accompany our forthcoming proposal on Basel III.

More favourable treatment of publicly guaranteed loans under the NPL prudential backstop

- As mentioned above, while NPL stocks remain high in some Member States, significant progress has been made in recent years, with banks strengthening confidence in their balance sheets, reducing the level of NPLs and improving operational efficiency. The minimum loss coverage requirement for non-performing loans (the so-called 'NPL backstop') ensures that banks set aside sufficient funds to cover the risks associated with loans that have become non-performing.
- Official export credit agencies (ECAs) typically issue guarantees on behalf of national governments to provide credit protection for loans used for financing exports. NPLs guaranteed by such agencies receive a preferential treatment under the NPL backstop.
- It is proposed to temporarily extend this preferential treatment to NPLs guaranteed by the public sector in the context of measures aimed at mitigating the economic impact of the Coronavirus pandemic in accordance with EU State aid rules. This would recognise the similar characteristics shared by export credit agencies guarantees and Coronavirus related guarantees.

What are the proposed changes to the calculation of the leverage ratio?

The years leading up to the 2008/2009 financial crisis were characterised by an excessive build up in banks' balance sheets in relation to their capital (i.e. excessive leverage). During the financial crisis, losses and the shortage of funding forced banks to reduce significantly their leverage over a short period of time. This amplified downward pressures on asset prices, causing further losses for banks which in turn led to further declines in their capital. The ultimate results of this negative spiral were a reduction in the availability of credit to the real economy and a deeper and longer crisis.

As a consequence, the CRR introduced a new regulatory tool, namely the leverage ratio, which is a ratio between a bank's capital and its exposures. Initially banks were only asked to calculate it, report it to their supervisors and disclose it publicly. The last revision of the CRR introduced a capital requirement based on the leverage ratio that will become applicable on 28 June 2021. In line with the Basel framework, the CRR provides a discretion to temporarily exclude central bank reserves from a bank's leverage ratio calculation in exceptional circumstances. The exemption may be granted by competent authorities for a limited period of time not exceeding one year. Any impact of the exclusion is fully offset via a mechanism that increases a credit institutions' individual leverage ratio requirement in a proportionate manner.

The discretion, which is intended to facilitate the effective transmission of monetary policy measures, will become applicable together with the leverage ratio requirement. However, the current Coronavirus pandemic shows that the offsetting mechanism, when applicable, would be too restrictive and that its application would actually not facilitate an effective transmission of monetary policy and, ultimately, could force an institution to deleverage by selling assets or reducing the level of lending to the real economy.

To enhance the flexibility to act appropriately during possible future crises, the proposal modifies the offsetting mechanism. In particular, a bank that would exercise the discretion would still be required to calculate the so-called "adjusted leverage ratio", but unlike under the existing rule, it would be required to calculate it only once at the moment it exercises the discretion. The adjusted leverage ratio would not change throughout the full period during which the discretion is exercised.

The Commission also proposes to bring forward the application of several agreed measures that incentivise banks to finance employees, SMEs and infrastructure projects, as well as to invest in software.

What is the proposed date of application of the exemption of certain software assets from capital deductions?

As a general rule, intangible assets, including software, have to be deducted from banks' regulatory capital. The last revision of the CRR introduced provisions to change the regulatory treatment of "prudently valued software assets", which are not materially affected in a gone concern situation. Banks will not be required anymore to deduct these particular software assets from their Common Equity Tier 1 capital. The EBA was mandated to develop a draft Regulatory Technical Standard (RTS) to specify how this exemption from deductions is to be applied. The application date of the revised treatment of software assets has been set to 12 months after the entry into force of this RTS.

In the context of the accelerated up-take of digital services as a consequence of the coronavirus pandemic, it is proposed to bring forward the date of application of the exemption and allow banks to use it as soon as the RTS enters into force.

What is the proposed date of application of the specific treatment envisaged for certain

loans backed by pensions or salaries?

The last revision of the CRR introduced a more favourable prudential treatment of loans to pensioners or employees with a permanent contract that are backed by the borrower's pension or salary. This revision was due to become applicable on 28 June 2021. The application of this treatment in the context of the coronavirus pandemic would incentivise banks to extend lending to employees and pensioners. To allow banks to benefit from the more favourable treatment already during the coronavirus pandemic, it is proposed to advance the date of application of the specific treatment.

What is the proposed date of application of the revised SME supporting factor and the new infrastructure supporting factor?

The SME supporting factor refers to a capital reduction factor in the amount of capital that banks need to hold for prudential reasons in respect of loans they grant to SMEs. The SME supporting factor was introduced by the CRR to allow credit institutions to ensure an adequate flow of credit to this particular group of companies. The last revision of the CRR increased the capital discount for exposures to SMEs (the "revised SME supporting factor"), and introduced a new discount on the capital requirements for exposures to entities that operate or finance physical structures or facilities, systems and networks that provide or support essential public services (the "infrastructure supporting factor"). This revision was due to become applicable on 28 June 2021.

The supporting factors allow for a more favourable prudential treatment of certain exposures to SMEs and infrastructure with a view to incentivise banks to prudently increase lending to those entities. In the context of the Coronavirus pandemic, it is essential that banks continue lending to SMEs and supporting infrastructure investments. The proposal therefore advances the date of application of the two supporting factors.

What are the next steps?

As regards the Interpretative Communication, the Commission will monitor its implementation in close cooperation with the ECB-SSM and national competent authorities.

The legislative proposals will be discussed by the European Parliament and the Council. The targeted changes envisaged in the legislative proposal need to happen quickly in order to have the intended effect. The Commission counts on the full cooperation of the Parliament and the Council to deal with our proposal as a matter of urgency and adopt this package already in June.

[1] European Banking Authority (EBA), European Central Bank Banking Supervision (ECB), the European Securities and Markets Authority (ESMA) and the Committee of European Audit Oversight Bodies (CEAOB).

[2] Basel Committee on Banking Supervision (BCBS) and the International Accounting Standards Board (IASB).

[3] <https://www.ifrs.org/news-and-events/2020/03/application-of-ifrs-9-in-the-light-of-the-coronavirus-uncertainty/>

[4] https://ec.europa.eu/info/consultations/finance-2020-retail-payments-strategy_en

https://ec.europa.eu/info/departments/financial-stability-financial-services-and-capital-markets-union/consultations-banking-and-finance_en

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