FINANCE

COVID-19: Maximising banks' ability to lend

3 June 2020

As the COVID-19 pandemic presents banks with unprecedented challenges, the European Commission has published a package of measures designed to support new lending to households and businesses.

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Best National Firm for Women in Business Law 2019, 2018 & 2017
Europe Women in Business Law Awards

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Europe Women in Business Law Awards

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Europe Women in Business Law Awards

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Managing Partners' Forum Awards

Ireland Client Service Law Firm of the Year 2018
Chambers Europe Awards

Advised on Equity Deal of the Year 2018 – Allied Irish Banks IPO
International Financial Law Review (IFLR) Europe Awards

BANKS FACE UNPRECEDENTED CHALLENGES

The COVID-19 pandemic has, in the words of the European Banking Authority (**EBA**), presented EU banks with "*unprecedented challenges*". In a note published on 25 May 2020 (The EU Banking Sector: First Insights into the COVID-19 Impacts), the EBA noted that while banks were in a stronger position at the outset of the COVID-19 pandemic than was the case with previous financial crises, profitability levels remain low, and banks' operational capacities are strained.

Measures recently taken by the EBA and by competent authorities,[1] are designed to enable banks absorb losses and continue to lend to households and businesses throughout the pandemic.

The European Commission (the **Commission**), with the same intention, recently published:

- proposed "quick-fix" amendments to the Capital Requirements Regulation (**CRR**)[2] (the **Amending Regulation**); and
- an Interpretative Communication in relation to the EU's accounting and prudential rules.

One of the Commission's aims is to enable banks to make the best use of the flexibility available within the current prudential and accounting framework, and to bring forward improved prudential treatment for certain categories of loans.

1 EBA: Statement on the application of the prudential framework regarding Default, Forbearance and IFRS 9 in light of COVID-19 measures (25 March 2020)

ESMA: Accounting implications of the COVID-19 outbreak on the calculation of expected credit losses in accordance with IFRS 9 (25 March 2020)

ECB: ECB Banking Supervision provides further flexibility to banks in reaction to coronavirus (20 March 2020)

ECB: FAQs on ECB supervisory measures in reaction to the coronavirus (last updated 3 April 2020)

Basel Committee on Banking Supervision: Basel Committee sets out additional measures to alleviate the impact of Covid-19 (3 April 2020)

International Accounting Standards Board: IFRS and COVID-19 (27 March 2020)

2 Regulation (EU) No 575/2013.

THE AMENDING REGULATION

AMENDING REGULATION: PROPOSED 'QUICK-FIX' CHANGES TO THE CRR	
Area	**Proposed change**
Mitigating the impact of IFRS 9 provisions on regulatory capital	The CRR allows banks, for a transitional period (2018-2022), to add back a portion of any increase in provisions due to the introduction of expected credit-loss (**ECL**) accounting[3] under IFRS 9[4] to their common equity tier 1 (**CET1**) capital. The Commission is concerned that the application of IFRS 9 during the pandemic could cause a sudden and significant increase in banks' ECL provisions. That would impact a bank's capital base, and adversely affect its ability to continue to lend. To mitigate this, for provisions incurred as of 1 January 2020, the Commission will extend the above transitional period by two years to 2024. In its Interpretative Communication, the Commission encouraged banks to make use of the flexibility provided by this transitional period, noting that uptake had been relatively low to date.
Leverage Ratio Buffer deferred	When the CRR was amended by the CRR II Regulation[5], a leverage ratio buffer requirement was introduced for global systemically important institutions. That requirement was due to apply from 1 January 2022, but will now be deferred until 1 January 2023. This ties in with the revised implementation timeline announced by the Basel Committee on Banking Supervision on 27 March 2020.
Preferential treatment under NPL Backstop extended	The minimum loss coverage requirement for non-performing loans (the **NPL Backstop**) is designed to ensure that banks set aside sufficient funds to cover the risks associated with non-performing loans (**NPLs**). NPLs that are used to finance exports, and that are the subject of credit protection issued by official export credit agencies, receive preferential treatment under the NPL Backstop. The Commission will extend this preferential treatment, on a temporary basis, to NPLs guaranteed by the public sector in the context of the pandemic.
Leverage Ratio	The CRR introduced a leverage ratio (a ratio between a bank's capital and its exposures), and the CRR II Regulation introduced a capital requirement based on that leverage ratio which was to apply from 28 June 2021. That will give banks a discretion to temporarily exclude central bank reserves from the calculation of their leverage ratios in exceptional circumstances. Competent authorities will be able to grant this discretion for up to one year. To balance the impact of this, an offset mechanism was planned whereby a bank's individual leverage ratio requirement would be proportionately increased where it availed of this discretion. The Commission's view is that the pandemic has shown that this offset mechanism would be too restrictive, and could force banks to deleverage by reducing lending to the real economy, or by selling assets. As a result, the Commission is proposing modifications to that offset mechanism whereby a bank would only need to calculate its adjusted leverage ratio at the time that it exercises the discretion. That ratio would then not change during the discretion period.
Exemption of certain software assets from a bank's CET1 capital	This exemption will be brought forward by twelve months. The EBA must develop regulatory technical standards (**RTS**) on the application of this exemption, and the exemption will now come into force on the date that those RTS come into force, rather than twelve months later.

3 With ECL accounting (which is a forward-looking approach), banks must recognise ECLs at all times, taking account of past events, current conditions and forecasted information. They must also update the amount of ECLs recognised at each reporting date to reflect changes in an asset's credit risk.

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

5 Regulation (EU) 2019/876.

AMENDING REGULATION: PROPOSED 'QUICK-FIX' CHANGES TO THE CRR	
Area	Proposed change
Prudential treatment of loans backed by pensions or salaries	The CRR II Regulation introduced favourable prudential treatment for loans backed by pensions or salaries, to incentivise banks to lend to pensioners and employees. This was due to come into force on 28 June 2021, but will instead be brought forward and come into force when the Amending Regulation comes into force (expected June/July 2020).
Prudential treatment of loans to SMEs	The CRR II Regulation adjusted the prudential treatment for loans to SMEs by increasing the available capital discount. This was due to come into force on 28 June 2021, but will instead be brought forward and come into force when the Amending Regulation comes into force (expected June/July 2020).
Prudential treatment of infrastructure loans	The CRR II Regulation introduced more favourable prudential treatment for exposures to entities that operate or finance physical structures or facilities, systems and networks that provide or support essential public services. This was due to come into force on 28 June 2021, but will instead be brought forward and come into force when the Amending Regulation comes into force (expected June/July 2020).

INTERPRETATIVE COMMUNICATION

On 13 March 2020, the Commission invited competent authorities to look at how flexibility provided for in the existing regulatory framework could be best used to mitigate the impact of the COVID-19 pandemic on the banking sector. Some of the resulting guidance was noted at the start of this briefing. The Commission's Interpretative Communication confirms this guidance, and clarifies how EU rules should be applied by banks and competent authorities in a flexible and responsible manner.

INTEPRETATIVE COMMUNICATION – KEY THEMES	
Theme	Detail
Use of flexibility and buffers	The Commission encouraged banks, during the pandemic, to: • make full use of the flexibility embedded in the IFRS 9 framework and existing prudential rules; and • make use of the capital buffers available to them so as to enable them to maintain lending to the real economy and to markets.
Banks' approaches to ECL under IFRS 9 should be flexible	As mentioned above, the Commission is concerned that the application of IFRS 9 during the pandemic could cause a sudden and significant increase in banks' ECL provisions. Such an increase would impact a bank's capital base, and adversely affect its ability to continue lending. In line with the statement on IFRS and COVID-19 published by the International Accounting Standards Board on 27 March 2020, the Commission emphasised that banks are not expected to apply their existing ECL approaches in a mechanical manner during the pandemic when determining provisions. The Commission expects banks to use their judgment, so as to mitigate the impact of the pandemic on their ECL provisions without undermining investor confidence. As guarantees provided by governments or other entities reduce ECLs (even though they do not reduce default risk), banks should take these into account in their ECL calculations.

INTEPRETATIVE COMMUNICATION – KEY THEMES

Theme	Detail
Credit risk and payment moratoria	When assessing, for the purposes of IFRS 9, whether there has been a significant increase in credit risk (**SICR**) in respect of a financial asset such as a loan, the Commission noted that: • banks should look at the remaining life of the relevant loan; • the probability of default over the life of the loan should not significantly increase if there is a short-term probability of default as a result of the pandemic; • the Commission agrees with ESMA[6] that a temporary COVID-19 support measure (such as a payment moratorium) that does not significantly impact the net economic value of a financial asset such as a loan will not be a "*substantial*" modification of that loan; • a loan should not be automatically viewed as having suffered a SICR simply because a COVID-19 payment moratorium has been applied; and • a loan that performed well pre-pandemic and that benefits from a COVID-19 payment moratorium should not automatically trigger a significantly higher-than-expected ECL provision under IFRS 9.
Dealing with customers	The Commission reminded banks that they should continue to: • identify situations where borrowers may face financial difficulties that could impact their long-term repayment capacity; and • apply sound underwriting and know-your-customer standards.
Treatment of public guarantees	The Commission asked the EBA to look at how public guarantees provided in response to the COVID-19 pandemic should be treated for risk mitigation purposes, and to provide further guidance.

6 ESMA: Accounting implications of the COVID-19 outbreak on the calculation of expected credit losses in accordance with IFRS 9 (25 March 2020)

ROLE OF THE BANKING SECTOR

Working together

The Commission emphasised the need for banks to work with one another, and with public authorities, to ensure that interbank lending, and lending to households and businesses across the EU, can continue.

Digital transformation

In light of the public health measures imposed in response to the pandemic, including social distancing requirements and the related move to remote working, digital banking will become increasingly important. The Commission noted that banks should accelerate the digital transformation of their business models, while remaining cognisant of the related fraud risk.

Dividends and share buy-backs

The Commission reiterated that banks should act prudently and that, in particular, they should preserve or strengthen their capital positions to safeguard their ability to continue to lend. It welcomed the number of banks that have decided to suspend dividend payments, and encouraged those who had not already suspended dividend payments and the carrying out of share-buybacks to do so.

Variable remuneration

The Commission reiterated that banks should adopt a conservative approach to the payment of variable remuneration, in line with the EBA's statement on dividends distribution, share buybacks and variable remuneration (31 March 2020).

NEXT STEPS

Amending Regulation

The Amending Regulation will now be considered by the European Parliament and the EU Council. The Commission is hoping that the Amending Regulation will come into force in June 2020.

Monitoring

The Commission, together with the ECB, the EBA and national authorities, will monitor how banks use the available flexibility in the applicable accounting and prudential frameworks. In particular, lending volumes and lending standards will be monitored to assess the flow of credit from the banks.

Basel III

The Commission plans to postpone the adoption of its legislative proposal on the final elements of the Basel III framework, but is still aiming for the remaining Basel III standards to be implemented across the EU by January 2023.

Helping consumers

The impact of the decline in households' disposable income following both job losses and decreased economic activity resulting from the pandemic will be considered by the Commission as part of its 2021 review of both the Consumer Credit Directive and the Mortgage Credit Directive.

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