Regulatory News Alert

European supervisors promote flexibility in light of the COVID-19 pandemic

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Context and objectives

On 20 March 2020, in light of the adverse systemic economic impact of the COVID-19 pandemic, the European Central Bank (ECB) announced further measures to provide banks with flexibility in their application of regulatory requirements in the context of the crisis.

More specifically, the ECB has introduced supervisory flexibility regarding the treatment of non-performing loans (NPLs), in particular to allow banks to fully benefit from guarantees and moratoriums put in place by public authorities to tackle the current distress.

Further to this, on 25 March 2020, the European Banking Authority (EBA) issued a statement to clarify a number of aspects on the functioning of the prudential framework that should help institutions to respond adequately to the current circumstances.

The statement aims at providing clarity to the EU banking sector on how to handle—in a consistent manner—aspects related to the:

i. Classification of loans in default
ii. Identification of forborne exposures
iii. Accounting treatment

In general, given the limited operational capability of banks in making in-depth assessments under the current circumstances, the EBA encourages institutions to fully use the flexibility embedded in the accounting and regulatory frameworks. This step should help banks to maintain soundness through the crisis and provide critical functions to the economy.
Prudential treatment of loans backed by public guarantees

The ECB assures that—within their remit and on a temporary basis—supervisors will exercise flexibility regarding the classification of debtors as “unlikely to pay” when banks call on public guarantees granted in the context of coronavirus. The supervisor will also exercise certain flexibilities regarding loans under Covid-19 related public moratoriums.

In addition, loans that become non-performing and are under public guarantees will benefit from preferential prudential treatment in terms of supervisory expectations about loss provisioning.

Lastly, supervisors will deploy full flexibility when discussing with banks the implementation of NPL reduction strategies, taking into account the extraordinary nature of current market conditions.

Prudential identification of default

The EBA emphasizes that the classification to default should be done under true circumstances where economic losses are likely to occur. To ensure this principle is being followed during the current crisis, the EBA reminds the institutions of the following aspects:

- Past due criteria: the EBA guidelines on the application of the definition of default account for the possibility that public moratoria may extend the period of 90 days. In this context, the EBA now clarified that public and private moratoria should be treated similarly to the extent they have similar purpose and characteristics. Further guidance will be provided by the EBA to help institutions define the criteria to determine such similarities

- Loan restructuring: an exposure should not be classified as defaulted if the obligor remains likely to meet its obligations under a renegotiated contract

- Materiality: the amounts overdue must exceed the materiality threshold

Nevertheless, the EBA still expects institutions to assess the obligor’s unlikeliness to pay on a case-by-case basis. Such individual assessments should be done in a careful manner and may not be automatized.

Classification of forbearance

The EBA states that public and private moratoria granted by governments and EU bodies as a response to the COVID-19 pandemic do not need to be classified as forbearance measures, as long as they are not borrower-specific but rather addressed to broad ranges of product classes.
Considerations on IFRS 9

The EBA expresses the view that the application of public or private moratoria do not automatically trigger the occurrence of a significant increase in credit risk under the IFRS 9 framework.

Institutions should carefully assess the extent to which the high degree of uncertainty and any sudden changes in the short-term economic outlook might result in impacts over the expected life of the financial instrument. Thereby, institutions should distinguish between obligors for which the credit standing would not be significantly affected in the long-term from those that would be unlikely to restore their credit worthiness.

When determining the expected credit losses (ECL), banks need to consider the mitigation provided by the existence of collateral or public guarantees. They may opt for the application of IFRS 9 transitional arrangements envisaged in the CRR. The ECB further recommends that all banks avoid pro-cyclical assumptions in their models to determine the loan loss provisions.

Next steps

The EBA and the ECB will continue to monitor current developments as well as the institutions’ practices in the current circumstances.

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