EU-Regulation

CAPITAL REQUIREMENTS REGULATION COVID-19 QUICK-FIX

cep**PolicyBrief** No. 2020-6

KEY ISSUES

Objective of the Regulation: In the COVID-crisis, credit granting by banks shall be uphold.

Affected parties: Banks and their borrowers.

Pro: (1) The regulation lowers capital costs of credits and upholds credit granting by banks.

(2) The extension of the transitional regime for the accounting of expected credit losses is appropriate but must remain temporary.

Contra: (1) Instead of allowing for an overall zero capital coverage for publicly guaranteed NPL, the capital coverage should reflect the default risk of the guarantor.

(2) Zero risk weights and lower limits for banks' exposures to sovereign bonds issued in foreign currency neglect exchange rate risks.

(3) The preferential treatment of software assets should be handled in a restrictive manner. The preferential treatment of exposures to SME or to infrastructure loans distort competition and represents an industrial policy measure that should be dealt with outside the sphere of financial regulation.

The most important passages in the text are indicated by a line in the margin.

CONTENT

Title

Proposal COM(2020) 310 of 28 April 2020 for a **Regulation** of the European Parliament and of the Council amending Regulations (EU) No 575/2013 and (EU) 2019/876 as regards **adjustments in response to the COVID-19 pandemic Informally agreed upon by the Council and the European Parliament on 10 June 2020.**

If not mentioned otherwise, page numbers refer to the Commission proposal. Recital and article numbers refer to the text of the agreement between the European Parliament and the Council, as formally adopted as a legislative resolution by the European Parliament on 18 June 2020 [P9_TA-PROV(2020)0157].

Brief Summary

► **Context and objectives**

– According to the Commission, the economic shock triggered by the COVID-19 pandemic requires immediate regulatory relief for banks in order to avoid a credit crunch [Recital 6].
– The Capital Requirements Regulation [Regulation (EU) No 575/2013, CRR, see cep**PolicyBrief**] already allows for flexibility, which increases the capacity of banks to grant loans and absorb losses in contexts of economic distress. Nonetheless, in the view of the critical economic scenario triggered by the COVID-19 pandemic, the Commission holds targeted adjustments to the CRR necessary and wants to amend it. [p. 2]
– The Capital Requirements Regulation (CRR) is amended in order to allow banks to channel funds to businesses and households more easily and to absorb the economic shock caused by the pandemic [Recital 6].
– On 10 June 2020, the European Parliament and the Council reached an informal agreement on the Regulation, which was consequently adopted by the Parliament on 18 June. The formal adoption by the Council is expected soon. This cep**PolicyBrief** summarises and assesses the agreement.

► **Expected credit loss (ECL) provisioning under IFRS 9: extension of the milder transitional regime**

– In 2017, the EU legislators introduced the International Financial Reporting Standard (IFRS 9) in the CRR [Regulation (EU) 2017/2396] [p. 2, Recital 10].
– As of 1 January 2018, many banks need to account expected credit losses (ECLs) instead of incurred credit losses (ICLs) [Art. 473a CRR].
– The shift to ECL accounting leads to an increase in provisions. This negatively impacts Common Equity Tier 1 (CET 1) capital – i.a. retained earnings, open reserves – and thus, banks' capacity to lend [p. 5].
– As a transitional measure, the current CRR already allows banks to add back to their CET 1 capital a portion of every increase in ECL provisions. This applies to the period 2018–2022. [p. 5; Art. 473a CRR]
– Given that the level of ECLs is expected to grow considerably in the near future, the above transitional rule will now be extended until 2024. Moreover, until 2021, banks are allowed to add back to their CET 1 capital any increase in new ECL provisions. As of 2022 this add-back may only be partial (75% in 2022, 50% in 2023 and 25% in 2024). [pp. 5 and 6, Recitals 11 and 12, Art. 1 point 7]

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- Banks that have hitherto decided not to make use of the transitional regime may revise their decision anytime during the new transitional period if the competent authority agrees [Recital 13, Art. 1 point 7].

► **Preferential treatment of non-performing loans (NPL) guaranteed by the public sector**

- The current CRR allows for preferential provisioning requirements for certain non-performing loans that were extended for export financing purposes and that are guaranteed or insured by official export credit agencies. For such NPL zero coverage is demanded for up to seven years, when the loans originated after 26 April 2019. [p. 6; Art. 47c (4) CRR]
- The current CRR's preferential treatment for selected NPL guaranteed by the public sector will now apply to all NPL – referring to loans established after 26 April 2019 – that are guaranteed by central banks, central governments, selected international organisations – i.a. European Stability Mechanism (ESM) – and multilateral development banks – i.a. European Investment Bank (EIB). It will also apply to NPL that are guaranteed by regional governments and public sector entities when, because of guarantees or revenue-raising powers, the risk of exposure to them is comparable to that to central governments. [Recital 8, Art. 1 point 1]

► **Preferential treatment of exposures to central banks and central governments denominated in the currency of another Member State**

- The current CRR provision that allows banks using the standardised approach to not back with own funds exposures to central banks and central governments is limited to debt issued in the local currency ("zero-risk weight") [Art. 144 (4) CRR]. For exposures to central banks and central governments denominated in the currency of another Member State a rating-based risk weight between 0% and 150% applies [Art. 114 (2) CRR].
- Until the end of 2022 and for all banks, the current CRR's zero-risk weight for selected exposures to central banks and governments will also apply to sovereign exposures denominated in the currency of another Member State. In 2023 and 2024 the risk weight rises to 20% and 50% of the rating-based risk weight assigned by the CRR to such exposures. [Art. 1 point 9]
- The current CRR sets limits for bank exposures to central governments and central banks in the currency of another Member State [Art. 400 (1) a and 493(4) CRR]. For such exposures these limits will now be relaxed. If agreed upon by the supervisory authority, until the end of 2023, banks may incur such exposures up to 100% of their Tier 1 capital. In 2024 and 2025 limits of 75% and 50% will apply. [Art. 1 point 9]

► **Deferral of the entry into force of the leverage ratio for global systemically relevant institutions (G-SII)**

- The leverage ratio is the ratio of a bank's Tier 1 capital to its total – non risk-weighted – assets and off-balance sheet items (Art. 429 CRR). The current CRR allows, as of 1 January 2022, for a maximum leverage ratio of 4.75% for global systemically important institutions (G-SII) [Art. 92 point 1a].
- The leverage ratio buffer requirement will now be deferred by one year, thus applying from 1 January 2023 [p. 6 and 7, Recital 13, Art. 2 point 2].

► **Exclusion of central bank exposure from the calculation of the leverage ratio**

- According to the current CRR, when calculating the leverage ratio, which takes effect as from 28 June 2021, all banks may exclude exposures vis-à-vis central banks – e.g. reserves or deposits held at the central bank – from their total assets, i.e. the denominator of the leverage ratio. This is possible only [p. 7; Art. 429a (1) (n), (5), (6) and (7) CRR]
  - for a maximum exclusion period of one year;
  - where the responsible supervisory authority determines and publicly declares, after consultation with the central bank, that exceptional circumstances exist that warrant the exclusion in order to facilitate the implementation of monetary policies;
  - for new exposures to the central bank in the same currency as the deposits held by the bank and that have an average maturity that does not significantly exceed the average maturity of the deposits taken by the bank.
- The exclusion of central bank exposures is fully offset by a correspondent adjustment of the leverage ratio requirement. The adjusted requirement applies for the duration of the exclusion. [p. 7; Art. 429a (7) CRR]
- The design of this mechanism, which applies only as from 28 June 2021, limits banks' ability to increase their central bank reserves and to impair the transmission of monetary policy during the COVID-19 crisis [p. 7; Recital 9]. Therefore, the following changes to the mechanism will now apply:
  - Banks may exclude all central bank exposures and not only those entered into after the exclusion period of maximum one year started [Art. 1 point 4];
  - The responsible supervisory authority may, after consulting the relevant central bank, determine exceptional circumstances and thus start the exclusion period also retroactively [Art. 1 point 4];
  - Banks have to calculate the adjusted leverage ratio only once, i.e. at the time when the bank chooses to use the exclusion. For this calculation, the value of the bank's [Art. 1 point 4]
    - total exposures shall be that of the first day of the exclusion period set by the supervisory authority,
    - central bank exposures shall be calculated as the daily average of these exposures over the full reserve maintenance period – set by the ECB – that precedes the start of the exclusion period.
- Until 28 June 2021, banks may exclude central banks exposures from their total assets in the calculation of the leverage ratio, when their responsible supervisory authority allows it [Art. 1 point 9].

- **Temporary prudential filters for unrealised gains or losses**
  - Falling bond prices for public debt due to the COVID-19 pandemic negatively impact banks' regulatory capital and their ability to lend as banks have to account for these unrealised losses. To neutralise this impact, "temporary prudential filters" are introduced. [Recital 15]
  - Banks may fully remove from the calculation of their CET 1 capital unrealised gains and losses accumulated in the year 2020 regarding exposures to central or regional governments or local authorities. In the years 2021 and 2022, these unrealised gains and losses can only be partially removed. [Art. 1 point 6]

- **Exclusion of COVID-19 related overshootings**
  - The current CRR requires banks to ensure that their internal models enable them to absorb possible trading losses ("backtesting requirements") [Recital 16].
  - An overshooting is a „failure[…] in the backtesting requirements". Depending on the number of overshootings, the CRR obliges the banks to hold more or less own funds. (Art. 366 CRR; Recital 16] Volatility in financial markets due to the COVID-19 pandemic could lead to a high number of overshootings, irrespective of the quality of the banks' internal models [Recital 16].
  - In the future, supervisory authorities may allow banks to exclude from the calculation of own funds overshooting events that took place in the period between January 2020 and December 2021 and that are not produced by deficiencies of the bank's internal models [Art. 1 point 9].

- **Early entry into force of preferential prudential treatment of software, SME and infrastructure loans**
  - The CRR allows banks to not deduct prudently valued software assets from their CET 1 capital [Art. 36 (1) (b) CRR]. The European Banking Authority (EBA) is currently drafting a Regulatory Technical Standard (RTS) to provide details on the deduction of such assets, which are to be adopted by 28 June 2020 [Art. 36 (4) CRR]. However, on 18 June 2020, the EBA has announced delays. It will adopt the RTS only in the second half of 2020.
  - The CRR's preferential prudential treatment of software assets will not apply, as initially planned, 12 months after the adoption of the Regulatory Technical Standard (RTS) but as of the date of their entry into force [Art. 2 point 3; Art. 3 (7) Regulation (EU) 2019/876].
  - Under the CRR, banks can apply a more favourable prudential treatment of non-defaulted loans to small and medium enterprises ("SME supporting factor") and of exposures to entities that operate or finance infrastructures that support essential public services ("infrastructure supporting factor") [Art. 500 and 500a CRR].
  - The CRR's current preferential prudential treatment of loans to small and medium enterprises and to entities that operate or finance infrastructures will already apply as of the date of entry into force of the proposed Regulation and not only as of 28 June 2021 [Art. 2 point 1; Art. 3 (2) Regulation (EU) 2019/876].

Statement on Subsidiarity by the Commission

The improvement of the banks' ability to lend and absorb losses in the context of the COVID-19 epidemic can be better achieved at the EU level.

Policy Context

The Commission has adopted an interpretative Communication [COM(2020) 169] which provides information on the flexibility that the currently applicable CRR offers to banks for keeping intact their ability to grant loans and absorb losses. In the course of the last months, European Supervisory Authorities provided temporary capital and operational relief for banks. This is notably the case for the ECB, which has – for banks directly supervised by it – set to zero the provisioning requirements for NPL with a public guarantee (see here) and for the EBA (see here).

Legislative Procedure

28.04.20	Adoption by the Commission
10.06.20	Informal Agreement between the European Parliament and the Council
18.06.20	Adoption by the European Parliament
Open	Adoption by the Council, Publication in the Official Journal of the European Union, entry into force

Formalities

Competence:	Art. 114 TFEU (Internal Market)
Type of legislative competence:	Shared competence (Art. 4 (2) TFEU)
Procedure:	Art. 294 TFEU (ordinary legislative procedure)

ASSESSMENT

Economic Assessment

According to the European Banking Authority (EBA), EU banks increased their capital buffers (CET 1 ratio) to roughly 15% by the end of 2019 from 9% in 2009. Banks' ability to cover losses is thus much higher than during the financial crisis and has so far prevented the COVID-19 crisis from turning into another financial crisis. In the economic policy answer to this massive and cross-sectoral crisis, liquidity and credit granting is playing an important role in order to allow for a swift re-start of the economy and to avoid insolvencies. In this context, Member States (through national programmes) as well as the ECB (through the PEPP purchasing programme) have taken far-reaching decisions. At the same time, private banks are incentivised to continue to grant credit to crisis-struck enterprises by the ECB (e.g. through TLTRO conditions which reward credit granting) and by this quick-fix to the CRR-Regulation.

This quick-fix to the CRR lowers capital costs of credits which upholds credit granting by banks.

It does so, however, at a time of very high uncertainty regarding future lockdowns caused by a possible second COVID-wave. In case these risks materialise, not all financial actors may be able to carry the risks they entered into. Depending on the scale of future defaults, public intervention may then be inevitable. To avoid such as scenario, it is of utmost importance that bank supervisors prevent moral hazard of banks and ensure high standards of credit granting also in crisis times. Many of the regulation's easings concern the capital costs of banks holding public debt. This reflects the fact that a crisis as fundamental as the COVID-crisis requires decisive public action and hence public debt will rise. It is however highly problematic that the insight that the existing bank-state ties have to be disrupted is put into question again. It is not tolerable to treat public debt as risk-free, least of all in the Eurozone.

Lower provisioning requirements for NPL with a public guarantee set capital free and positively affect banks' lending capacity. But this is sustainable only if the guarantee proves credible. The public guarantee de-facto reflects a claim by the bank against the guarantor (often the Member State). **Instead of allowing for an overall zero capital coverage for publicly guaranteed NPL, the capital coverage should reflect the default risk of the guarantor**, e.g. as expressed by ratings. In general, the preferential treatment will strengthen the unfavourable bank-state nexus that the banking union aims at reducing.

Zero risk weights and lower limits for banks' exposures to sovereign bonds issued in foreign currency reinforce this trend. These changes incentivise non-Eurozone countries to issue debt in Euro and may lower refinancing costs of these countries. However, they **neglect exchange rate risks** that may negatively impact on – the already ignored – sovereign default risks. The same goes for the temporary prudential filters for unrealised losses on sovereign bonds.

Although in general, there are good reasons to provision for expected losses, at times of a sudden and massive negative shock such the COVID-19 pandemic, expected losses may be overestimated. Strict provisioning may then have strong pro-cyclical effects as banks would have to substantially increase provisions. This could impair credit supply and increase expected losses even further. **The extension of the transitional regime for ECL accounting is appropriate, but this must remain temporary.**

The preferential treatment of software assets should be handled in a restrictive manner as the value of tailor-made bank software to third parties can often be expected to be rather low. **Exposures to SME or to infrastructure loans** are not per definition less risky than other exposures. Their preferential treatment **distorts competition and represents an industrial policy measure that should be dealt with outside the sphere of financial regulation.**

Legal Assessment

Legislative Competency

Unproblematic, as Article 114 TFEU (internal market) is the legal basis for the existing CRR.

Subsidiarity and proportionality with respect to Member States

Unproblematic.

Compatibility with EU Law in other Respects

Unproblematic.

Summary of the Assessment

This quick-fix to the CRR lowers capital costs of credits which upholds credit granting by banks. Instead of allowing for an overall zero capital coverage for publicly guaranteed NPL, the capital coverage should reflect the default risk of the guarantor. Zero risk weights and lower limits for banks' exposures to sovereign bonds issued in foreign currency neglect exchange rate risks. The extension of the transitional regime for ECL accounting is appropriate, but this must remain temporary. The preferential treatment of software assets should be handled in a restrictive manner. The preferential treatment of exposures to SME or to infrastructure loans distort competition and represents an industrial policy measure that should be dealt with outside the sphere of financial regulation.