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Management Consulting & Solutions

COVID19 AND BANK LOANS IN EUROPE

SUPERVISORY RESPONSE AND CREDIT-RELATED TOOLS

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SPECIAL REPORT 2020

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Under the special circumstances due to the COVID19 pandemic, CRIF Group renews its commitment to provide customers and other financial institutions with timely updates on the changing supervisory landscape and appropriate tools to face unprecedented changes in credit origination and monitoring.

This short note offers a brief overview of the most significant changes indicated by EU and euro area supervisors, and a preview of how they are going to impact the banks' origination and monitoring processes.

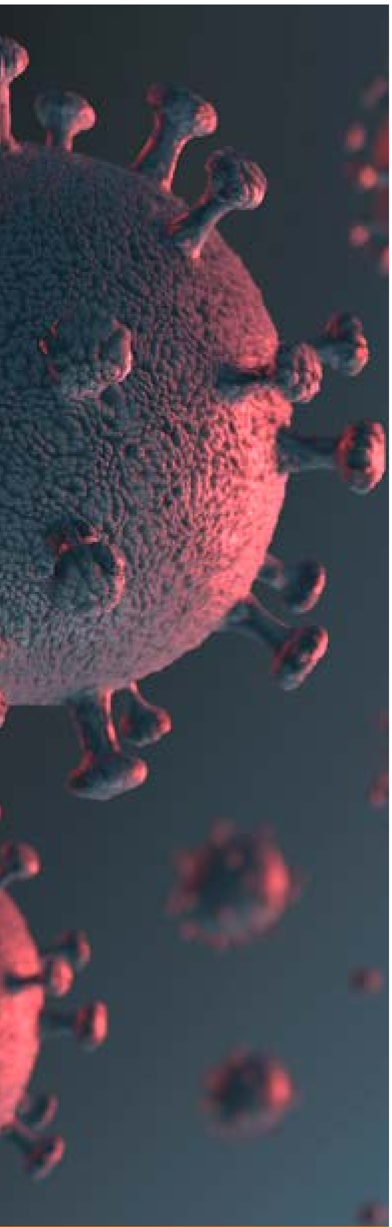
To get further assistance and learn more about the solutions and transformation services that CRIF has been deploying over the last weeks, see the "contacts" section at the end of this note.

How European bank supervisors are reacting to the COVID19 pandemic

The European Banking Authority (EBA) and the euro area's Single Supervisory Mechanism (SSM) have increasingly recognised that the impact of COVID19 on the real economy requires extraordinary measures to provide banks with adequate flexibility and protect them from overly procyclical effects.

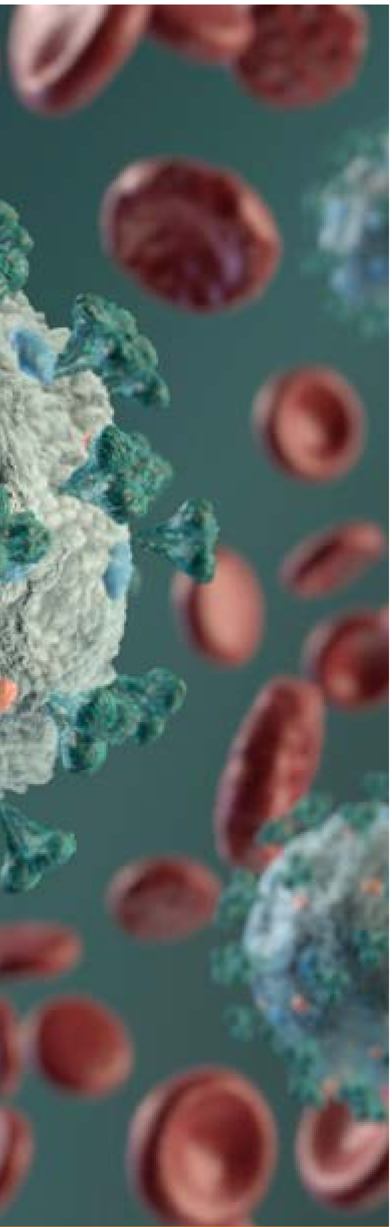
Their statements and guidelines have been backed up by ESMA, the European Commission and other public policy bodies.

On March 3, 2020, the SSM Chair sent *a letter to all significant institutions*, urging them to deploy contingency plans and backup facilities, while protecting the employees' health and stepping up defences against cyber-risk.



On March 12, 2020, the EBA announced its decision to *postpone the EU-wide stress test* exercise to 2021. On the same day, the ECB released a set of *measures to soften capital constraints* during the COVID19 crisis. First, banks were allowed to disregard the additional capital buffers imposed by the Basel 3 accord ("capital conservation buffer", CCB, and "counter-cyclical buffer", CCyB), limiting distributions accordingly, as well as the non-binding capital surcharge ("Pillar 2 Guidance", "P2G") that supervisors indicate to individual institutions as part of their annual supervisory review and evaluation process ("SREP"). Second, banks were allowed to use their liquidity coverage buffer, a pool of high-quality liquid assets that in normal times must exceed the cash outflows expected in the following 30 days, under a moderately stressed scenario. Finally, the amount of common equity Tier 1 capital ("CET1") that banks must use to meet the "Pillar 2 Requirement" ("P2R", a binding capital surcharge originating from each institution's annual SREP) was cut by roughly 45% and other capital instruments (additional Tier 1 and Tier 2) became eligible for P2R, as foreseen by a measure in the new Capital Requirements Directive ("CRD5") that would have entered into force only in 2021; overall, the ECB estimated that its measures concerning P2G and P2R could free up about €120 billion in CET1 capital. The SSM also announced that on-site inspections, data requests and other supervisory measures could be postponed, to avoid posing an unnecessary burden onto banks, and that the flexibility margins indicated in its NPL Guidance would be used to accommodate bank-specific needs.

	ECB	EBA	ESMA	IFRS Foundation	European Commission
Capital constraints	Relax buffers and P2G, constrain dividends				
Default identification	May avoid UTP if public guarantee is available	No forbearance if moratoriums are available			May avoid UTP if public guarantee is available
Supervisory provisioning	Preferential treatment for public guarantees				Legislative proposal to relax NPL backstop
NPL plans	Full flexibility for new NPLs				
IFRS 9	Use transitional rules	No SICR if short term noise. Look at lifetime changes. Consider public guarantees. Only use reasonable supportable information		Adjust forecasting procedures	SICR, guarantees and lifetime changes



On March 20, 2020, the SSM disclosed *further measures to enhance flexibility in default recognition and NPL provisioning.* This included a temporary waiver on the recognition of "unlikely to pay" ("UTP") debtors for credit exposures assisted by COVID19-related public guarantees and moratoriums, provided that they remain viable in the long term. In the same vein, on March 25 *the EBA clarified that public and private moratoriums*, following from COVID19 and addressed to broad ranges of products or customers, do not have to be automatically classified as forbearance measures (and could buy banks enough time to restructure credit exposures in a way that helps borrowers overcome their short-term liquidity constraints without triggering a default).

In its March 20 note, the SSM also stated that, in case such exposures become non-performing, they will benefit from a preferential treatment in terms of calendar provisioning (which could involve a 0% minimum coverage for the first seven years of the NPL vintage count). Again, "full flexibility" was mentioned regarding NPL reduction plans, although non-performing exposures accumulated prior to the COVID19 outbreak would not be "the focus" of supervisory mitigation measures. As noted in a *FAQ list,* a six-month extension was granted to banks to implement qualitative SREP measures, as well as remedial actions imposed in the context of on-site inspections and internal model investigations; the ECB will also postpone by six months its own decisions on internal models and follow up letters, unless banks explicitly ask for a pronouncement.

As far as accounting is concerned, the March 20 release encouraged banks to apply for the temporary capital relief measures developed by the European Parliament upon the first-time adoption of IFRS 9 (see box), and recommended that lenders avoid procyclical assumptions in the models used to quantify loan loss provisions. Regarding the latter, the SSM clarified that lifetime expected credit losses ("ECLs") used for IFRS 9 provisions should be based on long-term macroeconomic forecasts, including those in the ECB's publications, and take into account the relief measures granted by public authorities.

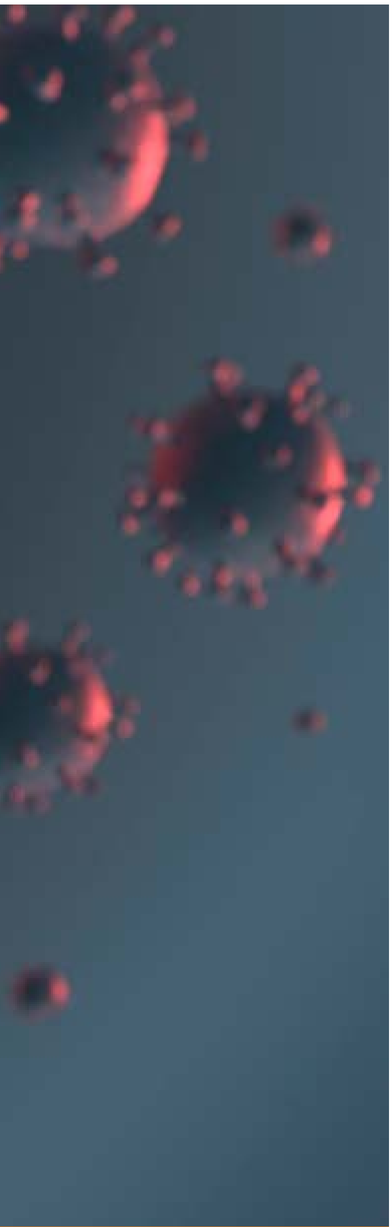
TRANSITIONAL ARRANGEMENTS FOR IFRS 9

Regulation (EU) 2017/2395 introduced a set of optional transitional arrangements for IFRS 9 in Article 473a of the CRR. Institutions were permitted, over a five-year period starting in 2018, to add back to their CET1 capital a portion of the additional provisions incurred due to the expected credit loss ("ECL") regime introduced by IFRS 9. The add-back amount decreases over time (from 95% in 2018 to 0% in 2023) and is made up of a static and a dynamic component.

The former mitigates the increase in loss allowances resulting from day-one application of IFRS 9; the latter addresses the potential impact of IFRS 9 in future years, but it is confined to provisions for non-defaulted exposures. Banks opting to use the transitional IFRS 9 arrangements could choose to discard the dynamic component; such decisions may be changed only once, upon supervisory approval.

The EBA's 25 March release further elaborated on accounting issues, with a focus on the identification of the the "significant increase in credit risk" (SICR) foreseen by IFRS 9. As is well known, exposures experiencing a SICR must be moved to Stage 2, where loan loss provisions must be increased to cover all ECLs until final maturity (as opposed to 12-month ECLs in Stage 1).

As a drop in macroeconomic conditions can boost the loans' probability of default and trigger a SICR, there is a risk that COVID19 causes a manifold increase in loan loss provisions. However, the EBA emphasised that a SICR can only be identified by looking at significant changes over the total expected life of the exposure, disregarding short-term noise (including public and private moratoria); accordingly, banks should distinguish obligors for which the credit standing will not be significantly affected by the current situation in the long term. Additionally the EBA stressed that, under IFRS 9, institutions are expected to use only "reasonable and supportable information" and should therefore decide what information can be seen as such under the current exceptional circumstances. In any case, in determining the impact on banks' income statements stemming from the recognition of ECLs, the mitigation provided by collateral or public guarantees would need to be considered.



The EBA's remarks are consistent with the recommendations issued on March 25, 2020, by the *European Securities and Markets Authority*. According to the ESMA, the emergence of a SICR can only be assessed holistically and should capture changes in the lifetime risk of default. Additionally, economic support programs deployed by governments under the COVID19 emergency should be considered in the assessment of a SICR whenever they reduce the lifetime default risk of an exposure (whereas COVID19-related moratoriums should not, in themselves, be seen as symptoms of a SICR). Furthermore, circumstances related to the coronavirus outbreak and to the ensuing economic relief measures may allow banks to rebut the IFRS 9 presumption that exposures experiencing a 30-day delay in payments have experienced a SICR.

Further *guidance was provided on March 27 by the IFRS Foundation.* The standard setters acknowledged that estimating ECLs on financial instruments may prove challenging during the COVID19 crisis, and highlighted the importance of using all reasonable and supportable information available, adjusting forecasting procedures to account for the current exceptional situation.

On March 27, the ECB *recommended that banks do not pay dividends* until the 4th quarter of 2020 and refrain from other distributions and share buy-backs aimed at remunerating shareholders. Four days later, the EBA urged all banks to refrain from dividends and other distributions in order to maintain a robust capitalisation; furthermore, it required that *variable remuneration be kept at a conservative level,* with a larger part of it being deferred for a longer period and/or paid out in equity. On the same day, the EBA announced that banks were allowed to *delay the submission of supervisory reporting data,* Pillar 3 documents and other data collection exercises.

On April 1, 2020, in a *letter to all significant institutions*, the SSM reiterated its request that banks use the transitional IFRS 9 provisions in the CRR (including the "dynamic component") and avoid excessively procyclical assumptions in determining their provisions. Concerning the latter, the ECB released a guidance document addressing the collective assessment of the SICR and the use of macroeconomic forecasts. This ECB guidance notes that a SICR may not affect all clients equally; hence, banks may use a top-down approach to stage transfers to mitigate the risk of generalised shift to Stage 2; alternatively, they may recognise lifetime ECLs only on a portion of the financial assets for which a SICR is deemed to have occurred.

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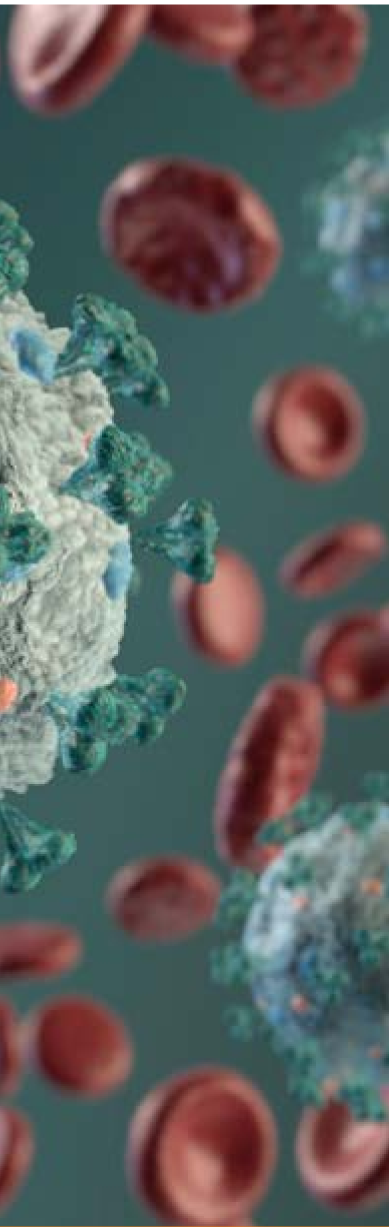
The SSM also encouraged banks to use long-term macroeconomic forecasts and historical information that is representative for the long-term horizon and free of recency bias. While it expects banks to use the ECB's 3-year forecasts as a benchmark, the SSM recognises that the economy might revert to long-term trends faster than expected and would not object to any judgement that a rebound might occur within 2020 given the current level of uncertainty.

On April 2, the EBA released *a set of guidelines on public and private moratoriums* related to COVID19 and applied before June 20, 2020. The guidelines specify that moratoriums do not trigger forbearance classification if they are based on national law or on broadly-applied, industry-wide private initiatives. The EBA clarifies that, as a general moratorium is not a forbearance measure, it may not give rise to a distressed restructuring.

On April 28, the European Commission weighed in with *two documents*, a legislative package (see box) aimed at proposing some quick fix to Regulation 575/2013 (the Capital Requirements Regulation, CRR) and *an interpretative communication* highlighting the flexibility margins available for banks under the existing rules. The latter deals with NPL classification and provisioning, from both a prudential and an accounting standpoint.

Concerning NPL classification, the Commission recalls the work done by the EBA and other supervisors, and advocates that rules on default and forbearance identification should not stand in the way of a widespread use of public guarantees and moratoriums. It also recalls that moratoriums freeze the day count for past-due exposures, as delays must be checked against the modified payment schedule. Finally, the Commission emphasises that, while the CRR requires the UTP status be assessed without considering guarantees, making recourse to a guarantee (e.g. to face temporary difficulties) does not in itself trigger a default.

As far as accounting rules are concerned, the Commission states that the temporary inability of households or businesses to pay back their loans because of COVID19 should not automatically trigger an increase in ECL-related provisions and that banks should not mechanically apply their pre-existing ECL measurement rules (as was also suggested by the *Basel Committee*). It also reiterates that a SICR should be assessed through a lifetime perspective, giving sufficient weight to scenarios based on long-term return to normal, and that moratoriums should not be seen, in themselves, as a sign of increased credit risk. Finally, it notes that guarantees do not affect the default risk of the borrower.



THE COMMISSION'S LEGISLATIVE PROPOSALS

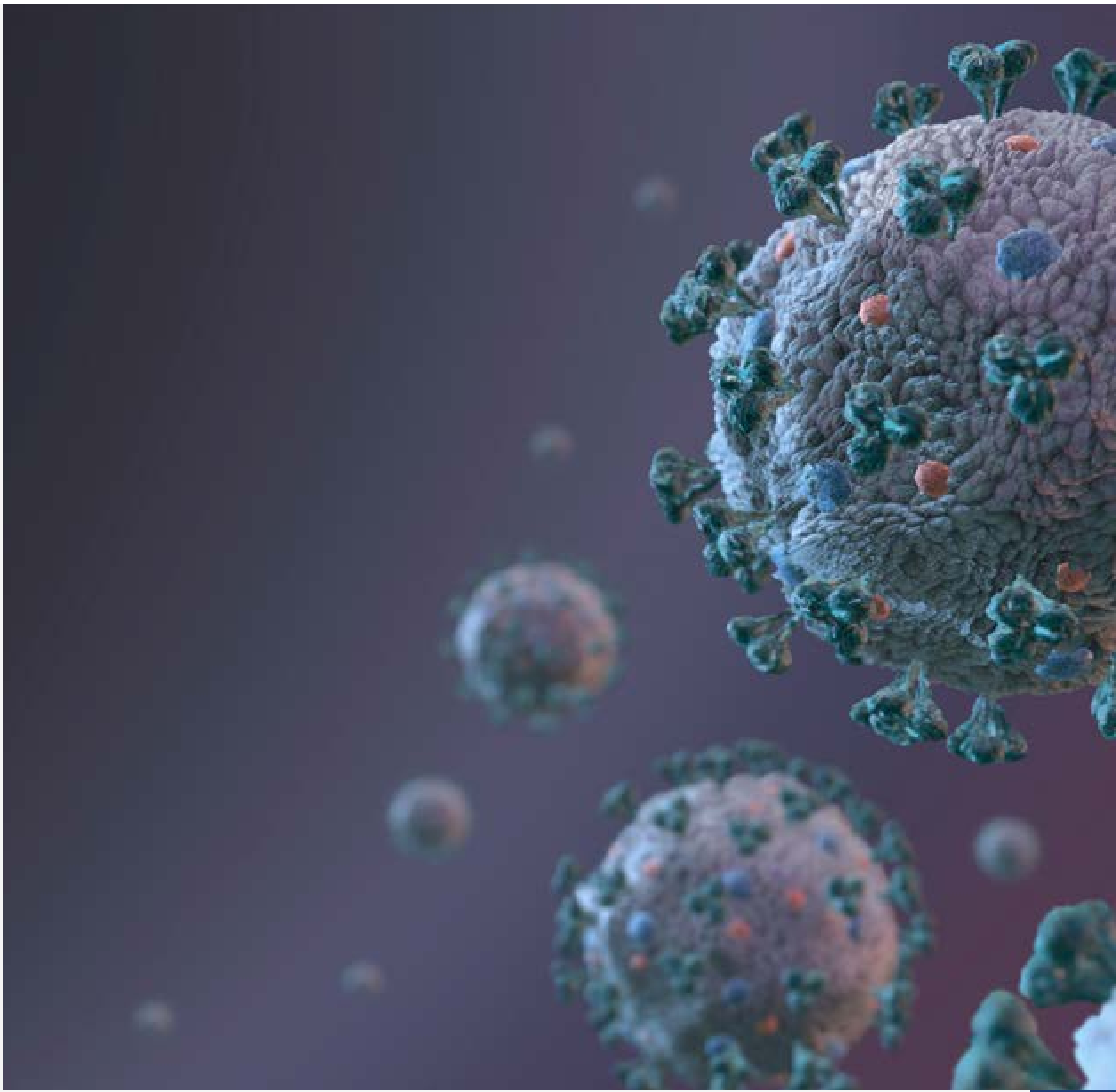
The legislative proposals issued by the Commission include a 2-year extension of the IFRS 9 transitional arrangements, whereby provisions incurred since 2020 could be added back to regulatory capital. Additionally, the additional leverage ratio requirement on global systemically important institutions would be postponed to 2023.

The Commission also proposes that the minimum loan loss coverage requirement in CRD5, known as "NPL backstop", be modified to foresee a preferential treatment for loans guaranteed by COVID19-related public measures.

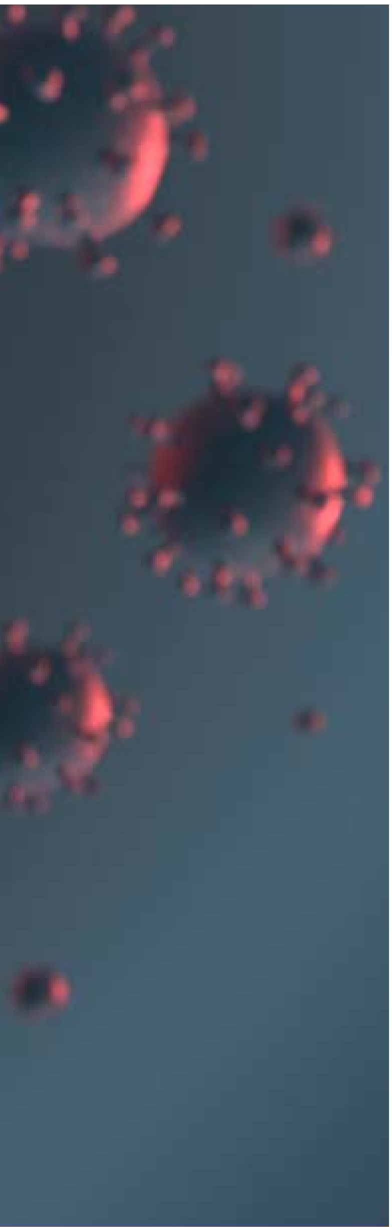
Finally, the implementation of some measures already approved by European legislators would be accelerated to increase the banks' lending capacity.

This includes the new rules cancelling the deduction of prudently-valuated software assets from regulatory capital, the more favourable prudential treatment of loans backed by salaries and pensions, the increased SME supporting factor and the new "infrastructure supporting factor" aimed at financing facilities, systems and networks that provide or support essential public services.

The Commission's legislative proposals will be discussed by the European Parliament and the Council, with a view to adopt the new package by June 2020.



HOW CREDIT RISK MONITORING
AND LOAN ORIGINATION TOOLS MUST EVOLVE TO COPE WITH COVID19



COVID19 will deeply affect credit process, including origination, monitoring and NPL management. The credit life-cycle, first requires to be managed through crisis mitigation actions, followed by a more strategic approach focused on evolving risk models, improving recovery processes and enhancing digitalization.

Origination may witness an increase in certain credit applications, first due to liquidity shortages and then to the recovery phase. As new loans must be issued quickly, money laundering and fraud will need careful consideration. To meet these challenges, banks will have to deploy "smart" origination procedures, especially for small loans assisted by State guarantees. Companies that are entitled to benefit from extraordinary support measures need to be identified, so that they can get cash advances against future State payments while all relevant information gets validated instantly, and data forgery risks are kept to a minimum.

To identify "sustainable borrowers" lenders will have to take into account:

- *industry, disentangling sectors that are more likely to be affected by COVID19 in a permanent way from candidates for a fast rebound;*
- *supply chain links;*
- *information on shareholders (e.g., triggering alert signals for companies where owners and top managers have changed in the last 3 to 6 months).*

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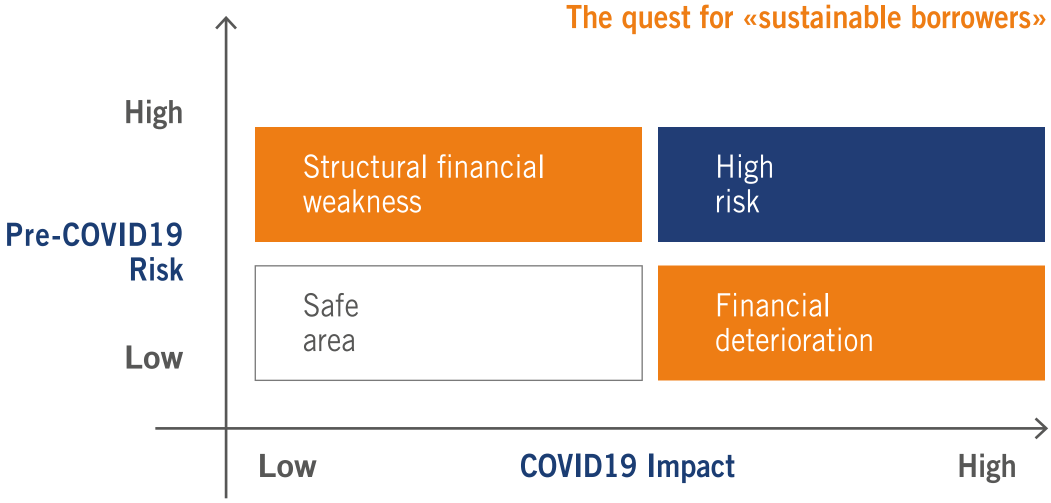
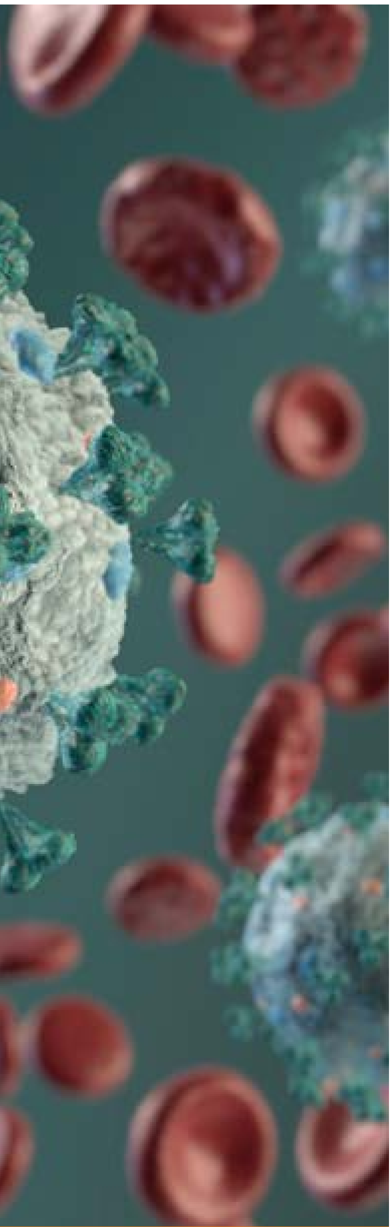
As the economy recovers in the months to come, remote digital services will prove crucial to boost the banks' ability to sustain credit volumes and generate new lending opportunities. By avoiding unnecessary interactions, origination processes must become leaner and user-friendlier; real-time access to external databases and batch remediation services will ensure that all relevant information is on board and fraud/money laundering vulnerabilities are kept to a minimum. Customer portfolios will have to be parsed and merged to external data (e.g. on broadband access, internet websites, e-commerce services) to select companies that are ready for a digital leap in credit origination. Lending will be closely integrated with each bank's digital transformation strategy, including, e.g., payment services. Incumbents will focus on how to implement digital transformation into their (largely physical) pre-existing procedures, while newcomers (typically fintechs), will have a chance to deploy brand new processes and technology based on full automation. Moreover, as the borrowers' digital attitude grows and gets reinforced by the COVID19 emergency, user experience will become a key parameter in preferring one lender over another.

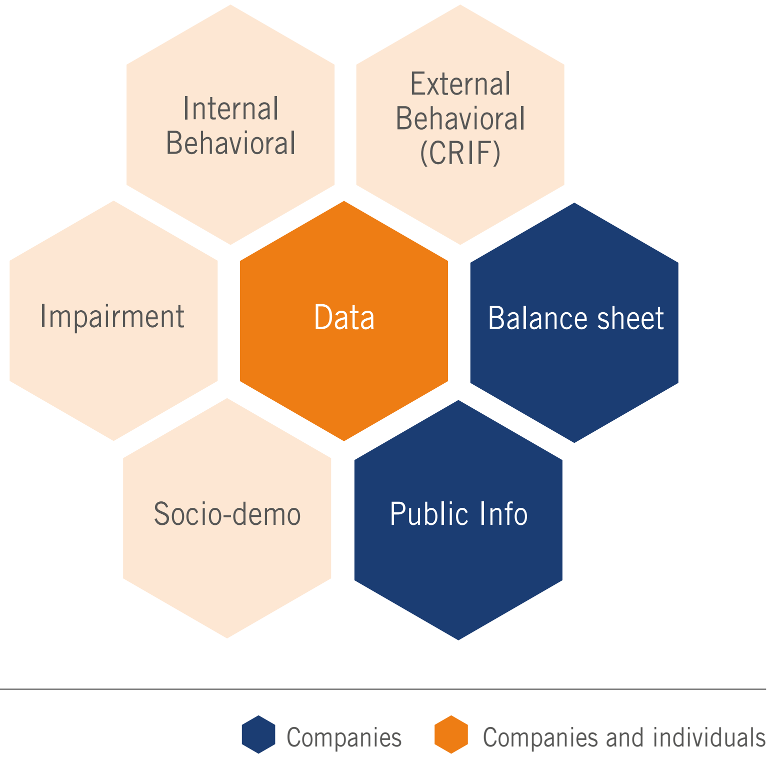
The quest for «sustainable borrowers»



As far as **monitoring** is concerned, we anticipate an increase in the number of counterparties affected by early warning signals. Unless properly managed (accounting for moratoriums and State guarantees), this could lead to a sharp increase in Stage 2 exposures and loan loss provisions; even for Stage 1 loans, bad macroeconomic forecasts may trigger lower valuations via the "forward looking" adjustment required by COVID19.



Information assets for early warning system



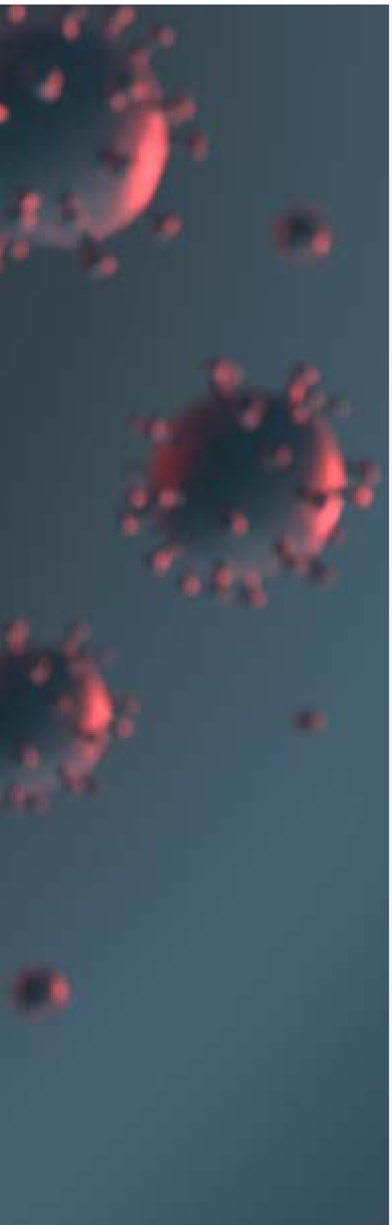
The challenge with early warning models is two-fold. On one hand, they need to become even more risk-sensitive, in order to identify crisis signals proactively and reduce the risk of Stage 2 transitions; this means that milder anomalies, such as a 30-day delay in payments may be used as the target event to calibrate new warning indicators (including e.g. transaction and supply-chain data, network analysis and forward-looking indicators). On the other hand, some stand-alone signals may need to receive a lower weight (or be filtered out altogether) when payment standstills have been agreed meeting the EBA criteria. Eligible borrowers should also be identified and prompted to apply for moratoriums, prioritising companies/industries that are more likely to suffer from short-term liquidity constraints.

As concerns SICR, banks should identify obligors for which creditworthiness will not be significantly affected in the long run, and set up analysis tools to motivate their choice to ignore 30-day delays in payments, if appropriate. Such tools may include an examination of the changes in lifetime risk experienced by exposures benefiting from moratoriums in the past, using internal and external data to identify different behavioural clusters. The effect of State guarantees should also be accounted for.

In the second half of the year, banks will also have to assess how to calibrate their risk parameters to account for the likely increase in default rates in 2020. This will affect IRB models, satellite models used for stress testing purposes, as well as models developed for IFRS 9 purposes (including for forward-looking adjustments). Such a calibration may hugely benefit from benchmark analysis, reinforcing internal evidence through external databases.

As for **NPL management,** banks will need to update their identification criteria for UTPs and non-performing forborne exposures (excluding borrowers affected by moratoriums or subjecting them to different provisioning schemes) and update their NPL reduction plans in a way that is both rigorous and feasible. While workout activities may have to be frozen for companies "shielded" by extraordinary COVID19-related measures, recovery actions must be brought to full speed for counterparties that do not benefit from moratoriums and guarantees, in order to mitigate the impact of calendar provisioning. Overall, collection activities must be planned over a medium to long-term horizon.

Building on the analytics and data developed over the last years, CRIF is ready to help in each one of areas mentioned above. Our focus on innovative solutions enables us to quickly deploy modular, turn-key solutions that can be fully operational within weeks and seamlessly integrate in existing processes and work-flows. As part of our response to the COVID19 emergency, we assist banks with sound, affordable tools used by hundreds of lenders worldwide, and keep investing on cutting-edge propositions, partnering with financial institutions in new projects that can quickly be brought to market.



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CRIF people are committed to creating value, supporting businesses to perform better and consumers to manage their credit health with a comprehensive range of professional skills and solutions.

CRIF is committed to digital financial inclusion and works responsibly to offer compliant innovative solutions to support its customers to enhance access to credit, granting digital access and use of financial services by excluded and underserved people.

From strategies to solutions, CRIF works alongside banks and financial institutions, insurance companies, businesses, telco and media, and utility and energy companies in every phase of the customer relationship to achieve growth, mitigate risk, reduce end-to-end processing costs and be compliant-ready. CRIF also offers services to consumers which are specially designed to help them take informed decisions in the credit and real estate markets.

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