Financial Risk&Regulation

The CRR is changing, the European Commission's banking regulatory response to the coronavirus crisis

Newsletter – July 2020

The Covid-19 pandemic and exceptional containment measures caused severe economic and financial shocks. Economic operators are facing supply chain disruptions, store closures, cross-border difficulties, unemployment and declining incomes. A number of EU and Member State packages of measures have been put in place to support the economy, complemented by the current CRR amendment, which aims to preserve financial stability and economic growth. The changes include IFRS 9 impairment adjustments, leverage ratio rules, and the regulation introduces favourable treatments related to the government securities portfolio and brings forward certain measures of CRR2. Examples of the latter are the modification of the SME multiplier, the 0.75 multiplier for infrastructure investments and the preferential risk weight of loans to pensioners or employees.

Impairment adjustment in accordance with IFRS 9 in CET1

Impairment losses calculated in accordance with IFRS 9 may increase significantly as a result of the Covid-19 pandemic crisis, which would contribute to the pro-cyclical behaviour of own funds. Although some flexibility is provided under IFRS 9, including, for example, taking due account of long-term economic trends, however, because of the point-in-time nature of the estimates, the procyclicality of impairment remains. As this may hamper the achievement of fiscal and monetary policy objectives, the EU authorities consider it appropriate to **extend the transitional period for CET1 capital impairment adjustments.**

The end of the transition period **is changed from the previous 2022 to 2024**, at the same time a correction formula is transformed. Changes in impairment levels are still broken down into exposures assessed under the standard and IRB methodologies, but **instead of the previous two temporal buckets, there are three of them**. In addition, there will be two types of correction factors, which are different in value and over time.

Favourable treatment of government bond portfolio

A significant temporary benefit is the possibility to **exclude other comprehensive income after 31 December 2019 related to government bonds and exposures to certain government participants when calculating CET1 capital**. The purpose of the change is to offset the decrease in capital caused by losses incurred on the government bond portfolio. This treatment is fully in force till the end of 2020, then decreases and cannot be applied after 2022.

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The amendment brought back a previous transitional rule, according to which **government bonds denominated in the domestic currency of another Member State** (e.g. Hungarian government bonds issued in EUR) receive more favourable treatment. On this base, they will be subject to a 0% risk weight until the end of 2022, and by 2023 the high risk limit will also be higher. They will be phased out (over 2 years) afterward.

Leverage ratio reliefs

Until June 27, 2021 central bank exposures, including reserves and banknotes, **may be disregarded** in calculating the leverage ratio. This is subject to the condition that the central bank deems it appropriate for the implementation of monetary policy, and in addition to other quantitative and qualitative restrictions, the value of the indicator calculated without exemptions must also be disclosed.

When calculating the leverage ratio, the favourable application related to **the exposure value of regular-way purchases and sales** is brought forward. Accordingly, institutions applying settlement date accounting should roll back the effects. Cash receivables and payables can only be offset if they are settled in the DVP system and the instrument is accounted for in the trading book.

Other CRR amendments

Back-testing is an integral part of internal market risk models, in which a number of VaR overshoots have been observed due to the crisis. In the Commission's view, this is in many cases not due to errors in internal models, **so competent authorities have the possibility to exclude 2020 VaR overshoots from back-testing.**

Previously, non-performing exposures guaranteed or insured by official export-credit agencies (ECAs) were exempted from the deduction from CET1 capital (as regards the applicable amount of insufficient coverage for non-performing exposures). The amendment extended this to **non-performing exposures guaranteed by national governments or other public bodies with similar risk mitigation.**

Advanced CRR2 discounts

This amendment also affects the CRR2 package, in which there has been change in case of implementation deadlines. The introduction of the following measures was brought forward by 27 June 2020.

- **CRR2 has introduced a reduced risk weight of 35% for loans to pensioners and employees (subject to special rules)** that meet the criteria for payment method, insurance, income-related instalment and maturity. These special rules include, for example, that the loan repayment must be deducted from the wage by the employer and transferred directly to the lending bank.
- **The SME multiplier is considered by the EU to be an important tool for maintaining healthy economic circulation, thus CRR2 has extended this tool**. The previous limit of EUR 1.5 million has been increased to EUR 2.5 million, and the discount will not be lost above the limit, the multiplier will be changed to 0.85.
- **CRR2 has introduced a multiplier of 0.75 to support the financing of physical structures or facilities, systems and networks that provide or support basic public services**. There are a number of criteria for its use, in addition to low risks and predictable cash flows, environmental considerations must also be considered.

In addition, the EBA has recently issued a consultative version of the RTS on prudently assessed software assets, under which **the deduction of software from CET1 capital may be waived in certain cases.** The deadline for consultation is 9 July, after which there will be at least a few more months for the final draft to be published by EBA and adopted by the Commission. Unlike previous plans, the legislation will take effect immediately upon adoption.

A further facilitation is **that the introduction of the leverage ratio buffer for globally systemically important institutions will be postponed to 1 January 2023.**

As a review of the functioning of the prudential framework, the Commission shall report on the justification for **giving competent authorities additional powers in the event of market disruption** with regard to internal market risk models and the limitation of payments by institutions.

The CRR changes made quickly in response to the coronavirus crisis are favourable to banks, and include a number of facilitations to ensure capital adequacy and maintain lending activity. In this context banks will be forced to take action, as more favourable prudential rules can be applied in capital requirement calculation to the end of the second quarter of 2020. However, this assumes a quick response, and taking advantage of benefits is often a resource-intensive task that involves evaluating regulatory options, performing calculations reliably, and in some cases, senior management decisions and supervisory communications.

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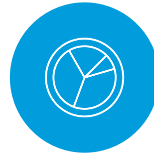
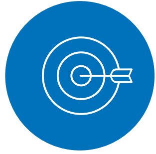
Extension of the transitional provisions related to the introduction of IFRS9 by 2 years due to high expected impairments.



Exclusion of certain central bank reserves from the leverage ratio for a 1 year period, amendment of the detailed rules for regular-way transactions.



Other comprehensive income of the government bond portfolio may be omitted from the calculation of CET1 capital, which may mitigate the decrease in own funds.

Software assets do not need to be deducted from own funds in some cases – RTS will take effect sooner, EBA is still working on it.

The previous rule on favorable risk weight of **government bonds denominated in other EU currency** will return, 0% until 2022, after which it will be phased out gradually in 2 years.

Earlier introduction of a preferential risk weights (35%) applicable to **loans covered by salary or pension.**

Minimum level of impairment – in addition to export credit agencies, **public sector guaranteed and secured loans also receive a preferential treatment.**

Advancing the introduction of a **new SME and infrastructure discount factor.**

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