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From:	Ms Christine LAGARDE, President of the European Central Bank
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To:	Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of the European Union
Subject:	OPINION OF THE EUROPEAN CENTRAL BANK of 20 May 2020 on amendments to the Union prudential framework in response to the COVID-19 pandemic (CON/2020/16)

Delegations will find attached the above mentioned opinion.

EUROPEAN CENTRAL BANK

EUROSYSTEM

EN **ECB-PUBLIC**

OPINION OF THE EUROPEAN CENTRAL BANK

of 20 May 2020

on amendments to the Union prudential framework in response to the COVID-19 pandemic

(CON/2020/16)

Introduction and legal basis

On 6 and 12 May 2020 the European Central Bank (ECB) received a request from the Council of the European Union and the European Parliament, respectively, for an opinion on a proposal 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[1] (hereinafter the 'proposed regulation').

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union since the proposed regulation contains provisions affecting (1) the task of the European System of Central Banks (ESCB) to define and implement monetary policy in accordance with the first indent of Article 127(2) of the Treaty, (2) the ECB's tasks concerning policies relating to the prudential supervision of credit institutions in accordance with Article 127(6) of the Treaty and (3) the ESCB's contribution to the smooth conduct of policies pursued by the competent authorities relating to the stability of the financial system, as referred to in Article 127(5) of the Treaty. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

General observations

The unprecedented implications of the global crisis triggered by the coronavirus (COVID-19) pandemic have prompted public authorities globally to take swift and decisive actions aimed at ensuring that credit institutions can continue to fulfil their role in funding the real economy and are able to support economic recovery, notwithstanding the likely increasing losses they will face due to the crisis.

The ECB has made use of the supervisory flexibility permitted by the current legal framework to support credit institutions to keep providing credit to households, viable businesses and corporates hardest hit by the current economic fallout[2]. In this regard the ECB provided temporary capital and operational relief[3]

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1 COM(2020) 310 final.

2 See blog post by Andrea Enria, Chair of the Supervisory Board of the ECB of 27 March 2020, Flexibility in supervision: how ECB Banking Supervision is contributing to fighting the economic fallout from the coronavirus, available at the ECB's banking supervision website at www.bankingsupervision.europa.eu.
See also FAQs on ECB supervisory measures in reaction to the coronavirus, available at the ECB's banking supervision website at www.bankingsupervision.europa.eu.

and announced further flexibility in the prudential treatment of loans backed by public guarantees[4]. The ECB has also encouraged institutions to avoid excessive procyclical effects in the application of the International Financial Reporting Standard (IFRS) 9[5], reduced temporarily the qualitative market risk multiplier to cater for the extraordinary levels of market volatility[6] and issued a recommendation on dividend distributions aimed at preserving capital resources within the banking system to enhance its capacity to support the real economy[7]. These measures have represented a very significant support in addressing the current crisis, with important synergies between the ECB's measures as a banking supervisor and its monetary policy actions as a central bank.

Other authorities have also taken action, notably the Basel Committee on Banking Supervision (BCBS) and the European Banking Authority (EBA), through prudential measures of a complementary nature which have benefitted from international coordination. Furthermore, national governments have launched very significant support programmes, including public guarantees and moratoria on payments of credit obligations.

Against this backdrop, the ECB fully supports the Commission's initiative to increase the capacity of credit institutions to lend and to absorb losses related to the COVID-19 pandemic, while still ensuring their continued resilience[8]. The targeted adjustments to Regulation (EU) No 575/2013 of the European Parliament and of the Council[9] (CRR) are welcomed, as they further increase the capacity of the banking system to mitigate the economic impact of the pandemic and support recovery, while preserving the key elements of the prudential framework. Furthermore, some elements of the proposed regulation are complementary to the mitigating supervisory measures taken by the ECB and certain measures agreed recently by the BCBS require amendments to the Union legal framework to become operational. Any further adjustments to the proposed regulation should not fundamentally alter the prudential framework, which should continue to respect agreed Basel standards and avoid further fragmentation of the European single rulebook.

As a further general observation regarding the readiness to provide loans to the economy, the ECB points to the following. If the Common Equity Tier 1 (CET1) ratio of credit institutions falls below the level of the combined buffer requirement, credit institutions can distribute resources only within the limits of the

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3 See ECB press release of 12 March 2020, ECB Banking Supervision provides temporary capital and operational relief in reaction to coronavirus, available at the ECB's banking supervision website at www.bankingsupervision.europa.eu.

4 See ECB press release of 20 March 2020, ECB Banking Supervision provides further flexibility to banks in reaction to coronavirus, available at the ECB's banking supervision website at www.bankingsupervision.europa.eu.

5 See ECB press release of 20 March 2020, ECB Banking Supervision provides further flexibility to banks in reaction to coronavirus, available at the ECB's banking supervision website at www.bankingsupervision.europa.eu.

6 See ECB press release of 16 April 2020, ECB Banking Supervision provides temporary relief for capital requirements for market risk, available at the ECB's banking supervision website at www.bankingsupervision.europa.eu.

7 Recommendation of the European Central Bank of 27 March 2020 on dividend distributions during the COVID-19 pandemic and repealing Recommendation ECB/2020/1 (ECB/2020/19) (OJ C 102 I, 30.3.2020, p. 1).

8 See section 1 of the explanatory memorandum accompanying the proposed regulation.

9 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

maximum distributable amount[10]. If earnings turn negative, distributions are cancelled, irrespective of the size of the breach. Credit institutions might not be willing to use their buffers for additional lending due to concerns of being obliged to cancel Additional Tier 1 coupons and face the potentially negative reactions of market participants. Such behaviour would impair the intended beneficial effect of the buffer framework.

Specific observations

1. *Transitional arrangements for mitigating the impact of IFRS 9 provisions on regulatory capital*

1.1 Article 473a of CRR contains transitional arrangements allowing institutions to add back to their CET1 capital a portion of any increase in provisions due to the introduction of expected credit losses (ECL) accounting under IFRS 9. The transitional arrangements consist of two components: a static and a dynamic component. The static component allows credit institutions to partially neutralise the 'day-one impact' on CET1 capital of the increase in accounting provisions due to the introduction of IFRS 9. The dynamic component allows credit institutions to partially neutralise the impact of the additional (i.e. post-day-one) increase in provisions for exposures that are not credit-impaired. The existing transitional arrangements cover the period from 2018 to 2022[11].

1.2 On 3 April 2020, the BCBS agreed on amendments[12] to the existing transitional arrangements for the regulatory treatment of ECL in light of the COVID-19 crisis. The BCBS also clarified that jurisdictions which have already implemented the transitional arrangements (including the European Union) may choose in particular to add back less than 100% during 2020 and 2021, or take other measures to prevent the add-back from including ECL amounts established before the outbreak of COVID-19[13]. To reflect these considerations the proposed regulation envisages resetting the 5-year transition period which started in 2018 for the dynamic component only.

1.3 The ECB supports an amendment of Article 473a of CRR in order to allow credit institutions to add back to their CET1 capital an amount limited to the increase attributable to the dynamic component of the ECL provisions after 31 December 2019. Firstly, this solution would allow tailoring the scope of the additional measures to address the effects related to COVID-19, distinguishing them from the day-one impact that the increase in provisions had on CET1 capital due to the introduction of IFRS 9. Secondly, this solution would be fully compliant with the BCBS decision of 3 April 2020.

2. *Treatment of publicly guaranteed loans under the NPE prudential backstop*

2.1 According to Article 47c(4) of CRR, non-performing exposures (NPEs) guaranteed by official export credit agencies (ECAs) receive a preferential treatment in relation to deduction requirements under Article 47c(3) of CRR (the so-called prudential NPE backstop). In the case of NPEs guaranteed by ECAs, the part of the exposure covered by such guarantee only needs to be fully deducted after

10 See Article 141 of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

11 See section 5 of the explanatory memorandum accompanying the proposed regulation.

12 See BIS press release of 3 April 2020, Basel Committee sets out additional measures to alleviate the impact of Covid-19, available at https://www.bis.org/press/p200403.htm.

13 BCBS, Measures to reflect the impact of Covid-19, available at https://www.bis.org/bcbs/publ/d498.pdf.

seven years in NPE status, while there is no deduction requirement before that. For all other NPEs which are secured in full or in part by qualifying collateral, minimum deduction requirements gradually increase over time until the relevant NPEs are fully covered.

2.2 The proposed regulation envisages a temporary extension of the specific treatment of NPEs guaranteed by ECAs to NPEs guaranteed by national governments or other public entities, which are eligible as credit protection providers under the credit risk mitigation rules[14], provided that the guarantee or counter-guarantee is provided as part of support measures to assist borrowers during the COVID-19 pandemic[15].

2.3 The ECB welcomes the proposal to temporarily extend the more beneficial treatment of Article 47c(4) of CRR to NPEs guaranteed by national government or other public entities, which is also in line with the ECB's suggestion[16]. The proposal removes an arbitrary distinction between guarantees given by different public entities with a similar credit standing.

3. *Date of application of the leverage ratio buffer*

3.1 The Group of Central Bank Governors and Heads of Supervision (GHoS) which oversees the BCBS endorsed on 27 March 2020 that the timeline for implementing the final elements of the Basel III reform be postponed by one year, including the leverage ratio buffer for global systemically important banks, which will become applicable in the Union on 1 January 2022. The proposed regulation envisages an alignment of the applicable timeline in CRR with the new timeline endorsed by the GHoS i.e. 1 January 2023 rather than 1 January 2022[17].

3.2 The ECB supports the decision to make use of the extended timeline agreed at international level for the finalisation of the Basel III reforms for the purposes of their transposition into Union law. Postponing the application of the leverage ratio buffer for global systemically important banks will allow credit institutions a smoother adjustment, while remaining fully consistent with the substance and timeline agreed at international level. This will enable credit institutions to focus their operational capacity on the necessary measures to address the current crisis and foster economic recovery.

4. *Offsetting the impact of excluding certain exposures from the calculation of the leverage ratio*

4.1 The final leverage ratio standard published by the BCBS in December 2017[18] provides that, in order to facilitate the implementation of monetary policies, a jurisdiction may temporarily exempt central bank reserves from the leverage ratio exposure measure in exceptional macroeconomic circumstances. If this discretion is exercised, the Basel standards require a recalibration (i.e. an

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14 Letters (a) to (e) of Article 201(1) of CRR refer to (a) central governments and central banks; (b) regional governments or local authorities; (c) multilateral development banks; (d) international organisations exposures to which a 0% risk weight under Article 117 is assigned; (e) public sector entities, claims on which are treated in accordance with Article 116.

15 See the proposed new Article 500a of CRR.

16 See FAQs on ECB supervisory measures in reaction to the coronavirus.

17 See proposed amendment to Article 3(5) of Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012 (OJ L 150, 7.6.2019, p. 1).

18 BCBS, Basel III: Finalising post-crisis reforms, p. 144, available at https://www.bis.org/bcbs/publ/d424.pdf.

increase) of the leverage ratio requirement to offset the exclusion of central bank reserves. This discretion, which has been introduced into Union law[19], will become applicable on 28 June 2021.

4.2 The ECB notes that the experience of the global financial crisis clearly highlighted the need for a mandatory leverage ratio requirement in Pillar 1. It is widely recognised that the build-up of excessive leverage in the banking system was an underlying cause of the global financial crisis. The ECB therefore considers it important to fully preserve the role of the leverage ratio as a credible non-risk based backstop and to avoid exclusion of its major components.

4.3 The proposed regulation envisages a change to the recalibration mechanism as currently set out in CRR. In particular, a credit institution will be required to calculate the adjusted leverage ratio only once, on the basis of the value of the institution's eligible central bank reserves and total exposure measure on the day when the institution's competent authority declares that exceptional circumstances exist that warrant the exercise of the discretion. The adjusted leverage ratio will apply throughout the full period during which the discretion is exercised and will not change, unlike under the recalibration mechanism currently in force.

4.4 The ECB welcomes the fact that the proposed regulation implements a targeted exclusion of an increase in central bank reserves, which can support a smooth implementation and transmission of monetary policy measures. The ECB notes that an increase in central bank liquidity resulting from the conduct of monetary policy will lead to an increase in the quantity of reserves held by the banking system, as is the case for the recently announced monetary policy measures in relation to the COVID-19 crisis. While individual credit institutions are able to shift these reserves around, the banking system will not be able to avoid holding these additional reserves and the accompanying increase in the leverage ratio total exposure measure. In order for the exclusion to be fully effective the ECB suggests the following modifications.

4.5 The change to the recalibration mechanism applies from 28 June 2021. However, by the time a competent authority exercises its discretion, which could be on 28 June 2021 or a date thereafter, the amount of central bank reserves held by a credit institution could already have increased significantly owing to monetary policy measures. A recalibration based on the central bank reserves held by a credit institution on the date a competent authority exercises its discretion might not fully facilitate the implementation and effective transmission of monetary policy measures. This is because the increase in central bank reserves that these measures imply is expected to have largely occurred by that date. Therefore the exclusion of central bank reserves calculated at that date will create less capacity for banks for a potential increase in lending to the real economy. Furthermore, should there be a need to renew the exclusion at the end of the period during which the discretion is exercised (initially a maximum one-year period), the recalibration would be based on the amount of the reserves held at the renewal date, which may have further increased in the meantime. Given uncertainty over the duration of the exceptional circumstances, the recalibration mechanism may substantially impede the effectiveness of the measure in facilitating the proper implementation and transmission of monetary policy.

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19 See paragraphs 1(n) and 7 of Article 429a of CRR as amended by Regulation (EU) 2019/876.

4.6 Competent authorities should therefore be able to set the reference date for the recalibration so that the recalibration remains stable for the period of the exceptional circumstances. This would allow competent authorities, in consultation with central banks, to choose a date which marks the beginning of the period of exceptional circumstances, as evidenced by key monetary policy decisions[20]. This would provide certainty and clarity to market participants, and would support the smooth implementation and transmission of monetary policy.

4.7 In addition, competent authorities should be able to recalibrate on the basis of a reference period, rather than a reference date. The average amount of eligible central bank reserves over the period would then be taken into account in the recalibration. This would allow competent authorities to disregard any day-to-day variation of central bank reserves when setting the new minimum requirement for each institution.

5. *Possible further changes to certain aspects of market risk requirements*

5.1 The extraordinary levels of volatility recorded in financial markets since the outbreak of COVID-19 impact the capital requirements for market risk for institutions using the internal model approach for market risk in two ways: (a) the Value at Risk figures increase as a consequence of the observed higher volatility, and (b) the quantitative market risk multipliers reflecting the number of back-testing overshootings increase[21]. These developments impact the CET1 ratios of credit institutions and might also impact credit institutions' capacity to continue market making activities and provide market liquidity, adversely affecting the orderly functioning of the market. Moreover, an excessive increase of capital requirements for market risk would impede the objective to free up capital to support lending to the real economy.

5.2 The BCBS standard on market risk internal models contains sufficient flexibility for competent authorities with regard to the treatment of back-testing overshootings in extraordinary circumstances[22]. In particular, the BCBS standard acknowledges that even well-designed models might fail to predict unexpected high market volatility. In these extraordinary circumstances, even an accurate model might produce many exceptions in a relatively short period of time.

5.3 While CRR does not contain an explicit reference to the extraordinary circumstances described in the BCBS text, some flexibility for the competent authority in assessing the results of the back-testing is allowed. In particular, Article 366(4) of CRR provides that the supervisor has the discretion not to count overshootings resulting from actual losses where these are driven by factors other than model deficiencies, such as extraordinary market conditions. However, CRR does not allow the competent authority to apply a similar treatment to hypothetical overshootings and disregard them for the purposes of calculating the back-testing addend. Market disruptions caused by COVID-19 are expected to influence the number of hypothetical overshootings, in a manner similar to the number of actual overshootings.

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20 See ECB press release of 12 March 2020, Monetary policy decisions, available at the ECB's website at www.ecb.europa.eu.

21 See also EBA statement on the application of the prudential framework on targeted aspects in the area of market risk in the COVID-19 outbreak of 22 April 2020, available at the EBA's website at www.eba.europa.eu.

22 BCBS, MAR Calculation of RWA for market risk, paragraphs 99.65 to 99.69, available at https://www.bis.org/basel_framework/standard/MAR.htm.

5.4 As a result, compared to international standards, competent authorities are restricted in their available supervisory measures from achieving their objective of maintaining credit institutions' ability to provide market liquidity and to continue market-making activities in extraordinary circumstances, which play a critical role in supporting the real economy. Additional measures, such as disregarding overshootings (resulting from both actual and hypothetical losses) in extraordinary circumstances, would better achieve this objective. Hence, CRR should be amended to ensure that, in extraordinary circumstances, competent authorities can take appropriate action, in line with the BCBS standard. For this purpose, competent authorities should be given further flexibility which would allow them to temporarily adjust the number of overshootings (resulting from both actual and hypothetical losses) or take other appropriate action. Given that the extraordinary market conditions are not linked to specific individual entities, but the whole market, it would also be important that the competent authority should exercise this power across all supervised entities with regard to their respective internal models, rather than on an individual basis.

This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 20 May 2020.



The President of the ECB

Christine LAGARDE