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COVID-19: CRR Quick Fix

The amendments to Regulation (EU) No 575/2013 (CRR) and Regulation (EU) 2019/876 (CRR II)

On 26 June 2020 the new Regulation (EU) 2020/873 amending Regulation (EU) No 575/2013[1] (***CRR***) and Regulation (EU) 2019/876 (***CRR II***)[2] in response to the COVID-19 pandemic was published in the Official Journal of the European Union. It applies from 27 June 2020.

The COVID-19 pandemic and the comprehensive measures taken by the Union and its Member States to contain the coronavirus, sometimes even including a "lockdown" of whole economies, have an unprecedented and far-reaching impact on the European economy. In using the flexibility of the existing prudential framework, competent authorities across Europe provided institutions with capital and operational relief that aim to ensure that they continue lending to solvent and viable undertakings that suffer from the economic downturn. The importance of credit institutions during the COVID-19 pandemic was concisely formulated by BaFin president *Felix Hufeld* recently: "*This time banks are not part of the problem, […], but part of the solution.*"[3]

However, it became clear that the flexibility already embedded in the current regulatory framework was not sufficient to achieve the desired positive effects on lending capacity and loss absorption for which reason, on 28 April 2020, the European Commission published a proposal for a new Regulation (***COM Proposal***)[4] amending the CRR and the CRR II by introducing some targeted changes (known as "CRR quick fix" or CRR 2.5) that further support the existing measures and implement the arrangements agreed on international level, namely in the Basel Committee on Banking Supervision (***BCBS***).

In its opinion dated 20 May 2020[5] (***ECB Opinion***) the European Central Bank (***ECB***) welcomed the COM Proposal, proposed some modifications related to the leverage ratio and highlighted possible further changes to certain aspects of market risk requirements for banks that use the IRB approach in line with BCBS standards.

It its report[6] dated 10 June 2020 (***ECON Report***), the Committee on Economic and Monetary Affairs (***ECON***) proposed some additions and amendments to the COM Proposal, partly based on the specific observations made by the ECB in the ECB Opinion. The new Regulation (EU) 2020/873 largely incorporated the amendments suggested by the ECON.

The new Regulation will not change the regulatory framework fundamentally but it comprises the following amendments:

- IFRS 9 impairments - reset of the transitional arrangements, enabling institutions to compensate the impact of potential increases in IFSR 9 impairments recognised during the COVID-19 pandemic;
- Non-performing exposures (***NPE***) – preferential treatment of COVID-19 related public guarantees in the determination of the applicable amount of insufficient coverage for NPEs (so-called "***NPE Backstop***");
- Leverage ratio – targeted amendments relating to the exclusion of central bank reserves from the leverage ratio exposure measure;
- Leverage ratio – temporary calculation of the exposure value of unsettled regular-way purchases and sales.

1 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. 1–337).

2 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 PE/15/2019/REV/1 (OJ L 150, 7.6.2019, p. 1–225).

3 BaFin, Interview with Felix Hufeld, 3 June 2020, https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2020/fa_bj_2004_Corona_Hufeld_en.html.

4 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 of 28 April 2020 (COM(2020) 310 final).

5 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) 2020/C 180/04 (OJ C 180, 29.5.2020, p. 4–9)

6 A9-0113/2020

- Leverage ratio buffer – postponement by one year in line with the BCBS;
- Own funds - temporary neutralisation of capital impact of unrealised gains and losses relating to not credit-impaired sovereign exposures;
- Credit risk - treatment of public debt issued in the currency of other Member States;
- Market risk and value-at-risk (***VaR***) models – exclusion of overshootings from the back-testing addend;
- Capital relief - "frontloading" of CRR II provisions with a positive effect on own funds of institutions, including the preferred treatment of prudently valued software assets, the reduced risk weight for loans backed by pensions or salaries and the revised supporting factor for small and medium-sized entities (***SME***); and
- Distributions - report on additional supervisory powers to limit distributions;

IFRS 9 impairments - reset of the transitional arrangements for add-back amounts

The transition from the International Accounting Standard 39 (***IAS 39)*** to the International Financial Reporting Standard 9 (***IFRS 9***)[7] was accompanied by a change with a significant impact on an institution's own funds: The introduction of the expected credit loss (***ECL***) impairment requirement and its dependency on the reporting entity's determination on whether a significant increase in credit risk is given in respect of a financial instrument.

Paragraphs 5.5.3 and 5.5.5 of IFRS 9 require reporting entities to recognise a loss allowance on financial instruments[8] at an amount equal to the 12-month ECL (the so-called "stage 1"). If the credit risk on that financial instrument has increased significantly, the loss allowance must be measured at an amount equal to the lifetime ECL (the so-called "stage 2"). Given the potentially longer observation period, it is expected that any migration of a financial instrument from stage 1 to stage 2 will result in a significant increase of impairments and thus a depletion of the institutions' own funds. This provision was also meant as response to the lessons learned from the severe global financial crisis of 2007-2008.

The Union adopted IFRS 9 on 29 November 2016[9], requiring its application to the first financial year starting on or after 1 January 2018. Anticipating the potential impact of IFRS 9 accounting on the credit institutions' balance sheet and its common equity tier 1 (***CET 1***) capital and to mitigate any day-one impact and future impact 'post-day-one'[10], Article 473a(1) CRR authorises institutions until the end of and decreasing over the transitional period to include in its CET 1 capital an amount equal to the difference between the ECL impairments calculated in accordance with Paragraphs 5.5.3 and 5.5.5 of IFRS 9 and the total amount of impairments calculated on non-trading assets in accordance with IAS 39 (the so-called "***Add-back Amount***").

The Add-back Amount can be included in the CET 1 capital during the transitional period, which originally applied for five years from 1 January 2018 to 31 December 2022. The Add-back Amount that can be recognised in the CET 1 capital decreases during the transition period, because it must be multiplied with a phase-out factor that decreases over time: the phase-out factor was or is 95% in 2018, 85% in 2019, 70% in this year, 50% in 2021 and 25% in 2022.

Institutions had to decide on whether or not they make use of Article 473a(1) CRR and to notify the competent authority of its decision by 1 February 2018. However, they have the right to reverse its decision once during the transitional period, i.e. until 31 December 2022 (Article 473a(9) s. 2 CRR).

It is expected that the application of IFRS 9 during the slowdown of the economy caused by the COVID-19 pandemic will increase the ECL provisions significantly. In a first response, competent authorities across Europe encouraged credit institutions to use their discretion when determining whether the credit risk on a financial instrument has increased significantly (i.e. whether it migrates from stage 1 to stage 2) by using any reasonable and supportable forward-looking information that is available (Paragraph 5.5.9 to 5.5.11 IFRS 9). They also encouraged institutions to make use of the add-back arrangements available under Article 473a(1) CRR[11].

[7] The International Accounting Standards Board (IASB) published the final version of the International Financial Reporting Standard (IFRS) 9 on 24 July 2014.

[8] The ECL impairment requirement applies to all financial assets that are measured at fair value through other comprehensive income in accordance with paragraph 4.1.2 A of IFRS 9 (the loans and receivables, held-to-maturity investments and available-for-sale financial assets under IAS 39).

[9] Commission Regulation (EU) 2016/2067 of 22 November 2016 amending Regulation (EC) No 1126/2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council as regards International Financial Reporting Standard 9 C/2016/7445 (OJ L 323, 29.11.2016, p. 1–164).

[10] Article 473a(1) CRR is based on CAP90.7-17 (Transitional arrangements for expected credit loss accounting) of the consolidated Basel Framework, which distinguishes two approaches: a 'static approach', where the Add-back Amount is calculated once as of the effective date of the transition to IFRS 9, and a 'dynamic approach', where the Add-back Amount is calculated periodically to reflect the evolution of the institution's ECL impairments during the transition period. Article 473a(1) CRR implements both approaches. The day-one-impact is reflected in Article 473a(2) CRR; the dynamic approach, which measures the increase in ECL impairments since 1 January 2018, (but exempting the credit-impaired or defaulted financial assets within the meaning on Appendix A of IFRS 9) is implemented in Article 473a(3) and (4) CRR.

[11] ECB and the Federal Financial Supervisory Authority's (***BaFin***). Cf. ECB, FAQs on ECB supervisory measures in reaction to the coronavirus, updated 3 April 2020 (***ECB FAQs***), available at: https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200320_FAQs~a4ac38e3ef.en.html; BaFin Covid-

Further, they considered any first time use of the add-back arrangements applied for until 20 April 2020 as being automatically approved[12].

On 3 April 2020, the BCBS[13] agreed on certain amendments to the existing transitional arrangements for the regulatory capital treatment of ECL impairments (CAP90.7-17 of the consolidated Basel Framework): Irrespective of when a jurisdiction initially started to apply the transitional arrangements, it may allow banks to apply an Add-back Amount of up to 100% for the years 2020 and 2021[14] and to phase-out such Add-back-Amount over the following three years, i.e. until 31 December 2024 (the so-called "reset").

The new Regulation (EU) 2020/873 implements the BCBS agreement mainly by introducing a new paragraph (6a) to Article 473a CRR, allowing institutions to fully add-back to their CET 1 capital all increases in ECL impairments accounted for in the years 2020 and 2021[15]. The 100% add-back is limited to ECL impairments calculated in accordance with Paragraphs 5.5.3 and 5.5.5 of IFRS 9, i.e. it excludes any impairments stemming from credit-impaired or defaulted financial assets (the so-called "stage 3"). The Add-back Amount must be reduced during the following years between 2022 and 2024 in a linear fashion.

The reset of the add-back arrangements is accompanied by additional technical amendments, which include the institution's right to reverse its decision to use Article 473a(1) CRR any time during the transition period subject to prior approval of the competent authority (Article 473a(9) CRR).

In Article 473a(1), the new Regulation sets out an additional Add-back Amount in relation to allowances made between 1 January 2018 and 1 January 2020 (excluding loss allowances for lifetime ECL for credit-impaired financial assets).

NPE – preferential treatment of COVID 19 related public guarantees for NPE backstop

Article 47c(1) CRR requires institutions to determine for each NPE the applicable amount of insufficient coverage and to deduct such amount from its CET 1 items in accordance with Article 36(1)(m) CRR.

The insufficient coverage is determined as the difference between the exposure value of the relevant NPE and the sum of all specific credit risk adjustments (SCRAs), additional value adjustments, reductions or write-offs applied to such NPE. The exposure value of an NPE is multiplied by weighting factors, which distinguish between the secured part of the NPE, if any, its unsecured part and the period that has expired since the exposure has been classified as 'non-performing'.

NPEs guaranteed or insured by an official export credit agency (***ECA***) receive a preferential weighting factor of 0% in the first seven years following the NPE classification (Article 47c(4)(a) CRR), which means that they do not contribute to any CET 1 item deduction during that period.

In its frequently asked questions (FAQ) on coronavirus-related supervisory measures[16] the ECB indicated already that it will actively use the flexibility given under the ECB Guidance to banks on non-performing loans (***NPL Guidance***)[17] and the related Addendum[18]. Such actions include the recognition of COVID-19 related public guarantees and the extension of the preferential treatment foreseen in the NPL Guidance for NPEs guaranteed or insured by NCAs to such public guarantees. With respect to the Pillar 1 CRR minimum requirements, the ECB encouraged the European legislator to consider a similar approach for all exposures within the scope of Article 47a - 47c CRR that benefit from government guarantees.

The new Regulation (EU) 2020/873 follows the ECB's recommendation by extending the scope of Article 47c(4)(a) CRR to public guarantees issued by the eligible credit protection providers referred to in Article 201(1)(a) to (e) CRR, i.e., central government and central banks, regional government or local authorities, multilateral development banks, 0%-risk-weighted international organisations and public sector entities[19].

19 situation: new developments and important information from BaFin, updated 15 June 2020 (***BaFin FAQs***); available at: https://www.bafin.de/DE/Aufsicht/CoronaVirus/CoronaVirus_node.html.

[12] Cf. BaFin FAQ.

[13] BCBC, Measures to reflect the impact of Covid-19 of 3 April 2020 (d498), available at: https://www.bis.org/bcbs/publ/d498.pdf.

[14] Jurisdictions that have already implemented the transitional arrangements like Europe may choose to add back less than 100% during 2020 and 2021; cf. BCBS d498, footnote 7.

[15] The COM Proposal modifies the 'dynamic approach' only; the 'static approach' in Article 473a(2) CRR remains substantially unchanged.

[16] Cf. ECB FAQs

[17] ECB, Guidance to banks on non-performing loans, March 2017, available at: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf.

[18] ECB, Addendum to the ECB Guidance to banks on non-performing loans: supervisory expectations for prudential provisioning of non-performing exposures of March 2018, available at: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.npl_addendum_201803.en.pdf?81e79e706d0c3c817ea11d094a678ea8 (***Addendum***).

[19] While the COM Proposal suggested a temporary extension only, limited to guarantees and counter-guarantees provided as part of COVID-19-related support measures and complying with Union State aid rules the ECON proposed a permanent and unconditional extension to all public guarantees.; the new Regulation adopted the ECON approach.

Leverage ratio – targeted amendments relating to the exclusion of central bank reserves from the leverage ratio exposure measure

CRR II introduced a new Article 429a CRR which authorises institutions to exclude certain types of exposures from the calculation of the leverage ratio's total exposure measure. The new leverage ratio framework will apply as of 28 June 2021 (Article 3(2) CRR II).

In particular, Article 429a(1)(n) CRR[20] allows the exclusion of those coins and banknotes constituting legal currency in the jurisdiction of the central bank as well as claims on central banks, including the reserves held at the central bank. The exclusion is limited in time, not exceeding one year, and subject to the prior approval of the competent authority, which may only be given if the competent authority, after consulting the relevant central bank, determines and publicly declares that the exclusion is justified by exceptional circumstances that warrant the exclusion in order to facilitate the implementation of monetary policies (Article 429a(5) CRR). Further, the central bank reserves must be denominated in the same currency as the deposits taken by the institution, their average maturity must not significantly exceed the average maturity of such deposits (Article 429a(6) CRR) and they must be entered into after the exemption took effect (Article 429a(1)(n) CRR). Finally, institutions that benefit from the exemption must comply with the adjusted leverage ratio formula set out in Article 429a(7) CRR, which increases the institution's individual leverage ratio in a proportional manner.

Although not applicable yet, the COVID-19 pandemic indicated already that the new exclusion regime for central bank reserves, given the narrow scope of application and its dependency on deposits taken by the institution and recalibration mechanism to increase the leverage ratio requirement to offset the exclusion of central bank reserves, may actually not serve its purpose to support the central banks' monetary policy. It may also discourage institutions from drawing under central bank liquidity facilities in times of stressed liquidity.

The new Regulation (EU) 2020/873 implements a change to the offsetting mechanism by adjusting the leverage ratio formula set out in Article 429a(7) CRR, requiring the institution to calculate the adjusted individual leverage ratio only once, i.e. on the day on which the competent authority publicly declares that the conditions set out in Article 429a(5)(a) CRR (exceptional circumstances that warrant the exclusion) are met. Further, the wording of Article 429a(1)(n) CRR will be modified so that the exclusion is no longer limited to new central bank reserves.

In consideration of the modifications suggested by the ECB in the ECB Opinion to fully facilitate the implementation and effective transmission of monetary policy measures, the new Regulation implements some amendments to paragraphs (5) and (7) of Article 429a CRR and introduced Article 500b CRR setting out the temporary exclusion of certain exposures to central banks from the total exposure measure in view of the COVID-19 pandemic until 27 June 2021 by way of derogation from Article 429(4) CRR as a discretion of institutions.

Leverage ratio – temporary calculation of the exposure value of unsettled regular-way purchase and sales

The accounting treatment of unsettled regular-way purchases or sales of financial assets differs across and within accounting frameworks, with the result that those unsettled trades can be accounted for either on the trade date (trade date accounting) or on the settlement date (settlement date accounting). The term "regular-way purchase or sale" means a spot contract for which the terms require delivery of the financial asset within the time frame established generally by regulation or convention in the relevant marketplace (e.g. trade date plus 2 settlement days, T+2).

Banks that apply trade date accounting recognise a cash receivable for all unsettled sales and a payment obligation (or cash payable) for each unsettled purchase. In order to reduce the balance sheet extension, they may set-off these cash receivables and payables stemming from unsettled trades, if permitted under the applicable accounting standard. Banks that apply settlement date accounting will not account for any cash receivables and payables but replace the cash balance on its balance sheet with the purchased financial asset and vice versa the sold financial asset with the cash balance once the contract has been settled (on T+2).

For the purpose of the leverage ratio exposure measure, LEV30.10 of the consolidated Basel Framework requires banks that use trade date accounting to reverse out any offsetting between the cash receivables cash payables for unsettled purchases and to offset only between those cash receivables and cash payables that are settled on a delivery-versus-payment (DvP) basis and which are accounted at fair value through profit and loss. The offsetting of cash receivables and cash payables for unsettled trades that require DvP was so far not permitted under the CRR.

CRR II introduced a new Article 429g CRR which implements LEV30.10 of the consolidated Basel Framework. Article 429g CRR also clarifies that credit institutions that apply settlement date accounting must for purposes of leverage ratio calculation recognise cash receivables and cash payables for all unsettled trades, but subject to the same setoff rules available to credit institutions that apply the trade date accounting. The new

[20] Article 429a CRR is based on paragraph 26 of the Leverage Ratio Annex on to the BCBS document "Basel III: Finalising post-crisis reforms", December 2017 (d424), p. 144, available at: https://www.bis.org/bcbs/publ/d424.pdf

Regulation (EU) 2020/873 anticipates the application of the new Article 429g CRR (cf. new Article 500d CRR).

Postponement of leverage ratio buffer

On 27 March 2020, the BCBS's oversight body, the Group of Central Bank Governors and Heads of Supervision (***GHoS***)[21] decided to postpone the implementation of the final elements of the Basel III reform by one year. This includes the leverage ratio buffer for global systemically important banks. The new Regulation (EU) 2020/873 follows the GHoS' recommendation by modifying paragraph (5) of Article 3 CRR II setting out the entry into force and application of CRR II: The new application date for Article 92(1a) CRR will be 1 January 2023.

Own funds - temporary neutralisation of capital impact of unrealised gains and losses relating to not credit-impaired sovereign exposures

Pursuant to Article 35 CRR, except in the case of the items referred to in Article 33 CRR, i.e. cash flow hedges and changes in the value of own liabilities, institutions shall not make adjustments to remove from their own funds unrealised gains or losses on their assets or liabilities measured at fair value.

The new Regulation (EU) 2020/873 replaces the existing Articles 467 and 468 CRR by a new Article 468 CRR allowing institutions from 1 January 2020 to 31 December 2022 (the period of temporary treatment) to remove from the calculation of their CET 1 items the amount of unrealised gains and losses, provided they are accounted for as fair value changes of debt instruments measured at fair value through other comprehensive income, they relate to not credit-impaired exposures to central, regional and local governments and public sector entities, and they accumulated since 31 December 2019.

The amount that may be removed from CET 1 items decreases over time (100% in 2020, 70% in 2021, 40% in 2022). Institutions must inform the competent authority at least 45 days before the remittance date for the reporting of the information based on the temporary treatment. With the prior permission of the competent authority, an institution may reverse its initial decision once during the period of temporary treatment.

An institution that applies the temporary treatment has to recalculate (i) the amount of deferred tax assets deducted from CET 1 items in accordance with Article 36(1)(c) CRR or risk weighted in accordance with Article 48(4) CRR and (ii) the amount of specific credit risk adjustments without taking into account the effects that the expected credit loss provisions relating to sovereign exposures have on these items. Institutions that apply the temporary treatment have to disclose CET 1, Tier 1 and total capital (amounts and ratios) and the leverage ratio they would have if they did not apply that treatment.

Credit risk - treatment of public debt issued in the currency of other Member States

Until the end of 2017, for calculating risk-weighted exposure amounts the same risk weight (i.e. a 0% risk weight) was assigned in relation to exposures to the central governments and central banks of Member States denominated and funded in the domestic currency of any Member State as would be applied to such exposures denominated and funded in their domestic currency (Article 495(2) CRR in conjunction with Article 114(4) CRR). Pursuant to Article 114(6) CRR, in 2018 and 2019 reductions to the risk weights assigned to these exposures in accordance with Article 114 (2) CRR applied and in 2020 and onwards the risk weight applied to these exposures is fully in line with the risk weights set out in Article 114(2) CRR ranging from 0% to 150% depending on the credit quality step corresponding to an ECAI's credit assessment.

For large exposure purposes, by way of derogation from the large exposure limit of Article 395(1) CRR, the transitional arrangements set out in Article 493(4)-(6) CRR apply to public exposures until the end of 2020 with the permission of the competent authority for an exposure incurred on or after 12 December 2017 which would have been assigned a 0% risk weight in accordance with Article 495(2) CRR in force on 31 December 2017. For exposures incurred before 12 December 2017 the exemption from the application of the large exposure limits was grandfathered pursuant to Article 493(7) CRR.

By introducing a new Article 500a CRR[22], the new Regulation reintroduces transitional arrangements for exposures to central governments and central banks denominated in the currency of another Member State with respect to their treatment under the credit risk framework and to prolong the transitional arrangements with respect to their treatment under the large exposure limits.

In accordance with the new Article 500a(1) CRR, by way of derogation from Article 114(2) CRR (risk weights based on ECAI credit assessments) preferential risk weights apply to exposures to central governments and central banks denominated in the currency of another Member State until 31 December 2024 (0% risk weight until end of 2022 and a reduction of 80% and 50% to the risk weight applicable in accordance with Article 114(2) CRR in 2023 and in 2024 respectively).

[21] Cf. BCBS press release "Governors and Heads of Supervision announce deferral of Basel III implementation to increase operational capacity of banks and supervisors to respond to Covid-19" of 27 March 2020, available at: https://www.bis.org/press/p200327.htm

[22] The introduction of the new Article 500a CRR by the ECON was accompanied by the deletion of Articles 114(6) and 495(2) CRR and amendments to Article 150(1)(d)(ii) CRR.

In accordance with the new Article 500a(2) CRR, by way of derogation from Articles 395(1) CRR (large exposure limit) and 493(4) CRR (current transitional arrangements), competent authorities may allow institutions to incur exposures to central governments and central banks denominated in the currency of another Member State up to 100%, 75% and 50% of the institution's Tier 1 capital until end 2023, 2024 and 2025 respectively after taking into account the effect of credit risk mitigation.

In accordance with the new Article 500a(3) CRR, by way of derogation from Article 150(1)(d)(ii) (conditions for permanent partial use), following the prior permission of the competent authority and subject to the conditions of Article 150 CRR, institutions permitted to use the IRBA in the calculation of risk-weighted exposure amounts for one or more exposure classes may apply the Standardised Approach also to exposures to the central government and central bank that are assigned a 0% risk weight under Article 500a(1) CRR.

Market risk and VaR models – exclusion of overshootings from the back-testing addend

Pursuant to Article 366 CRR, institutions using the internal model approach for calculating the own funds requirements for market risk have to back-test their internal models daily so as to ensure adequate predictive accuracy of the internal model used. Failures in the back-testing requirements (so called "overshootings" or "outliers") above a certain number a year result in an additional quantitative multiplier being applied to the own funds requirements for market risk. In periods of extreme volatility as the one caused by the COVID-19 pandemic the back-testing requirement is highly procyclical, negatively impacting the CET 1 ratios of credit institutions.

While there is some supervisory flexibility for the competent authority in assessing the results of the back-testing in relation to overshooting resulting from actual losses not driven by model deficiencies in accordance with Article 366(4) CRR, unlike the Basel market risk framework[23] the current framework does not allow the competent authority to disregard hypothetical overshootings for the purposes of calculating back-testing addend.

The new Regulation (EU) 2020/873 introduces a new Article 500c in the transitional provisions of the CRR setting out the exclusion of overshootings from the calculation of the back-testing addend in view of the COVID-19 pandemic. By way of derogation from Article 366(3) CRR, competent authorities may, in exceptional circumstances and in individual cases, permit institutions to exclude from the calculation of the addend overshootings in back-testing on hypothetical and actual changes. The overshootings must not result from deficiencies in the internal model and has to occur between 1 January 2020 and 31 December 2021.

By 31 December 2021 the Commission shall report to the European Parliament and the Council whether exceptional circumstances that trigger serious market disturbance may justify during such periods competent authorities to exclude from institutions' market risk internal models overshootings not resulting from model deficiencies (new Article 518b (a) CRR).

"Frontloading" of capital relief

The CRR II provided for certain provisions which will have a positive impact on the own funds of institutions. The CRR II determined that they would apply from 28 June 2021. However, the new Regulation (EU) 2020/873 (by inserting paragraph (3a) to Article 3 CRR II) will accelerate their application so that they will be applied from the date of the entry into force of the new Regulation, i.e. 27 June 2020.

Standardised approach for credit risk - loans granted to pensioners or employees with permanent contract

The CRR II modified Article 123 CRR on the treatment of retail exposure under the standardized approach (***SA***) for credit risk by adding a new paragraph on loans granted to pensioners or employees with permanent contracts. To the extent secured by the borrower's pension or salary, institutions shall assign a risk weight of 35%, provided the following conditions are met: the pension fund or employer must have been authorised by the borrower to make direct payments to the institution, the risk of death, inability to work or unemployment is covered by an insurance policy, the monthly payments to be made by the borrower must not exceed 20% of the monthly pension or salary and the original maturity is less than 10 years.

Revised SME supporting factor

In order to support small and medium-sized enterprises (***SME***) and their contribution to the Union's economy[24], the CRR II revised Article 501 CRR to the effect that the institution's non-defaulted SME exposure of up to EUR 2.5 million will be subject to a 23.81% reduction in risk weighted exposure; SME exposure exceeding EUR 2.5 million will benefit from a risk weighted exposure reduction of 15%. Article 501 CRR applies to both the SA and the internal ratings-based approach (***IRBA***) for credit risk.

Entities operating or financing of infrastructure

The CRR II included a new preferred treatment for non-defaulted credit risk exposure to entities that operate or finance infrastructure that provide or support essential public services like broadband and energy networks,

[23] MAR32.6 of the consolidated Basel Framework.

[24] Cf. Recital (59) of CRR II: SMEs are "*...one of the pillars of the Union's economy as they play a fundamental role in creating economic growth and providing employment.*"

transport and electromobility infrastructure, education, research and innovation, and renewable energy and energy efficiency[25] (Article 501a CRR). Provided the extensive requirements set out in Article 501a(1)(a) to (o) CRR are met, institutions may benefit from a reduction in own funds requirements for credit risk of 25%. Article 501a CRR applies to both the SA and IRBA for credit risk.

The following provision of the CRR II will be applied from the date of the entry into force of the relevant regulatory technical standards (***RTS***) instead of 12 months after the entry into force of the relevant RTS (Article 3(7) CRR II as amended by the new Regulation (EU) 2020/873):

CET 1 deduction – exemption for prudently valued software assets

Article 36(1) CRR requires institutions to deduct certain positions from their CET 1 items, which include intangible assets. The CRR II modified the deduction regime for intangible assets by excluding prudently valued software assets, provided the value of the software assets is not negatively affected by the resolution, insolvency or liquidation of the institution.

The rationale for the preferred treatment of software assets is the evolution of the banking sector into a more digital environment[26], a general trend that gained new momentum during the COVID-19 pandemic when institutions focused on their operational resilience and business continuity and introduced remote working arrangements and an increased use of IT and telecommunication.

The new exclusion from deduction for prudently valued software assets is subject to the European Commission adopting RTS that will specify the materiality of negative effects on the value of software assets that do not cause prudential concern. The European Banking Authority (***EBA***) is required to submit draft RTS by 28 June 2020. The EBA has launched the consultation on the draft RTS on 9 June 2020[27]. Meanwhile, the Chairperson of the EBA José Manuel Campa informed the Commission that the draft RTS will not be completed on time by 28 June 2020, but only in the second half of this year. Members of the European Parliament (MEPs) have criticized the delay and asked the EBA to accelerate their work on the RTS[28] .

Distributions - report on additional supervisory powers to limit distributions

By 31 December 2021 the Commission shall report to the European Parliament and the Council whether exceptional circumstances that trigger serious financial market disturbance may justify additional binding powers to be granted to competent authorities to impose restrictions on distributions by institutions during such periods.

Outlook

The new Regulation (EU) 2020/873 will certainly increase the institutions' capacity to lend to solvent and viable undertakings, so that they can fulfil their task assigned by BaFin's president Felix Hufeld and be '*part of the solution*'. Whether the targeted changes will support institutions in absorbing the losses related to the COVID-19 pandemic, will depend on the future and on how the institution's loan portfolios perform. It would be desirable for the new Regulation to take effect quickly. However, among others this requires that the EBA and the Commission complete their work on the new RTS on prudently valued software assets in a timely manner; time is of essence.

[25] Cf. Recital (60) of CRR II.

[26] Cf. Recital (27) of CRR II.

[27] EBA, Consultation paper on Draft Regulatory Technical Standards on the prudential treatment of software assets under Article 36 of Regulation (EU) No 575/2013 (Capital Requirements Regulation - CRR) (EBA/CP/2020/11) of 9 June 2020,

[28] See *Börsen-Zeitung*, 18 June 2020: EBA criticized again - MEPs criticize delay in relief for banks.

Contacts

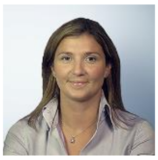
Markus Benzing
Partner
T +49 69 27 30 82 76
E markus.benzing@freshfields.com

Daniel Klingenbrunn
Associate
T +49 69 27 30 87 26
E daniel.klingenbrunn@freshfields.com

Holger Hartenfels
Counsel
T +49 69 27 30 81 91
E holger.hartenfels@freshfields.com

Friedrich Jergitsch
Partner
T +43 1 515 15 218
E friedrich.jergitsch@freshfields.com

Marc Perrone
Partner
T +33 1 44 56 54 56
E marc.perrone@freshfields.com



Emma Rachmaninov
Partner
T +44 20 77 85 53 86
E emma.rachmaninov@freshfields.com

Alexander Glos
Partner
T +49 69 27 30 81 91
E alexander.glos@freshfields.com

Gunnar Schuster
Partner
T +49 69 27 30 82 31
E gunnar.schuster@freshfields.com

Stella Klepp
Senior Specialist Regulatory
T +43 1 515 15 578
E stella.klepp@freshfields.com

Michael Raffan
Partner
T +44 20 78 32 45 01
E michael.raffan@freshfields.com

Janina Heinz
Counsel
T +49 69 27 30 86 67
E Janina.heinz@freshfields.com

freshfields.com