Clients&FriendsMemo

COVID-19 Update: The European Commission Proposes Urgent Amendments to the EU Capital Requirements Regulation

4 May 2020

On 28 April 2020, the European Commission (the "**Commission**") proposed a new Regulation to make targeted amendments to the EU Capital Requirements Regulation (575/2013) ("**CRR**") and the CRR II Regulation ((EU) 2019/876) ("**CRR II**") in response to the COVID-19 pandemic. Subject to the EU legislative process operating as anticipated, it is expected that these changes will apply in the UK until the end of the Brexit transition period (currently scheduled to end on 31 December 2020), although these changes will also be reflected in the UK "onshored" version of CRR which will apply after the end of the transition period.

The legislative proposal is accompanied by a Interpretative Communication (the "**Communication**"), which sets out the Commission's rationale for the changes and also provides guidance on the flexibility in the current EU accounting and prudential regimes during the COVID-19 pandemic. The Communication also sets out the Commission's view that the EU's existing prudential framework for banks contains sufficient flexibility for regulators to assist banks during the pandemic.

The Commission has, however, recognised that some further amendments to the CRR are required during the crisis. The proposed amendments are designed to improve banks' capacity to lend and to absorb losses. They include the following proposals:

IFRS 9 Transitional Measures

The Commission is concerned that the application of IFRS 9 during the COVID-19 pandemic may lead to a sudden significant increase in the Expected Credit Loss provisions of EU banks, which would result in an erosion of their capital. To counter this, the Commission has proposed an extension of the current transitional arrangements in the CRR by two years, in line with the international agreement of the Basel Committee on Banking Standards (announced on 3 April 2020). This would allow banks to add back to their regulatory capital any increase in new expected credit losses provisions that they recognise in 2020 and 2021 for their financial assets, which have not defaulted.

Calculation of the Leverage Ratio

In line with the Basel III standards, CRR II amends CRR to introduce a capital requirement based on the leverage ratio that will become applicable on 28 June 2021. The CRR provides a discretion to temporarily exclude central bank reserves from a bank's leverage ratio calculation in exceptional circumstances, for a period of up to 1 year. Under the current rules, any exclusion is to be offset via a mechanism that increases a bank's individual leverage ratio requirement in a proportionate manner, through the calculation of an "adjusted leverage ratio". The Commission is concerned that the current rules, relating to the offsetting mechanism, would be too restrictive and that their application would actually not facilitate an effective transmission of central bank monetary policy and, ultimately, could force a bank to deleverage by selling assets or reducing the level of its lending. The Commission is therefore proposing a modification so that a bank would only be required to calculate the adjusted leverage ratio once, at the time the discretion is exercised. The adjusted leverage ratio would not change throughout the full period during which the discretion is exercised.

Leverage Ratio Buffer

The Commission proposes to delay the implementation of the leverage ratio buffer for global systemically-important institutions from 1 January 2022 to 1 January 2023. This revised timetable for implementation of the Basel III standards has been agreed with the Basel Committee on Banking Standards.

Treatment of Publicly Guaranteed Loans Under the NPL Prudential Backstop

CRR requires a minimum loss coverage requirement for non-performing loans ("**NPLs**") (the so-called "**NPL backstop**") to ensure that banks set aside sufficient funds to cover the risks associated with loans that have become non-performing. NPLs guaranteed by official export credit agencies currently receive a preferential treatment under the NPL backstop under CRR; the Commission proposes to temporarily extend this preferential treatment to exposures guaranteed by a wider range of public sector agencies which have provided guarantees in order to alleviate the economic impact of the COVID-19 pandemic.

Acceleration of CRR II Measures

The proposal also calls for measures in CRR II, due to apply from June 2021, to be brought forward in response to the pandemic. These measures include the favourable prudential treatment of loans backed by an employee's salary or pension and the "SME supporting factor" and the "infrastructure supporting factor" (CRR II will amend CRR to provide for a reduction in the amount of capital that banks need to hold in respect of loans they grant to SMEs and separately for exposures to entities that operate or finance physical structures or facilities, systems and networks that provide or support essential public services).

Legislative Timetable

These proposals now have to make their way through the EU legislative process, involving consideration and approval by the Council of the EU (representing the individual member states) and the European Parliament. It should be noted that the previous iteration of the CRR/CRD package took a number of years to be finalised. In this crisis situation, however, the Commission has called upon the legislators to finalise and approve these changes by the end of June 2020, citing the targeted nature of these amendments and informal engagement with member states prior to the announcement of the proposals. It is plausible, therefore, that these measures could become applicable from the beginning of July 2020.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

Suzanne Bell	+44 (0) 20 7170 8549	suzanne.bell@cwt.com
Robert Cannon	+44 (0) 20 7170 8735	robert.cannon@cwt.com
Stephen Day	+44 (0) 20 7170 8535	stephen.day@cwt.com
Claire Puddicombe	+44 (0) 20 7170 8533	claire.puddicombe@cwt.com
David Quirolo	+44 (0) 20 7170 8635	david.quirolo@cwt.com
Nick Shiren	+44 (0) 20 7170 8778	nick.shiren@cwt.com
Daniel Tobias	+44 (0) 20 7170 8630	daniel.tobias@cwt.com
Michael Sholem	+44 (0) 20 7170 8545	michael.sholem@cwt.com