Box 3.3

AMENDMENTS TO EUROPEAN BANKING REGULATION IN RESPONSE TO THE COVID-19 PANDEMIC (THE CRR QUICK FIX)

On 26 June 2020 an amendment to the CRR[1] in response to COVID-19, commonly known as the "CRR quick fix", was published in the Official Journal of the European Union. Most of the amendments are temporary, although some apply on a permanent basis or bring forward reforms scheduled to come into force in 2021. The main changes introduced are described below:[2]

— **Prudential filter** – the option is introduced for institutions[3] to apply a temporary filter to neutralise the impact on CET 1 of changes in the value of sovereign debt instruments[4] measured at fair value through other comprehensive income (FVOCI). Changes in the fair value of these assets are recorded as other comprenhensive income and, as this is a CET 1 component, they have a direct effect on institutions' highest-quality capital.

The filter is to be applied over three years to unrealised gains and losses accumulated from 31 December 2019. In particular, the filter fully neutralises the effect in the first year, decreasing progressively in the following two years (100% in 2020, 70% in 2021 and 40% in 2022).

— **Review of the transitional arrangements applicable to expected credit loss accounting** – the favourable prudential treatment of provisions (which was introduced to ease the shift from the former incurred loss accounting to the current expected loss accounting models) is amended, resetting the schedule to be applied to provisions arising as a result of the impact of COVID-19.[5] These are proxied as the increase in the stock of provisions for exposures classified as Stage 1 or Stage 2 under IFRS 9 from 1 January 2020. The new treatment allows for these increases to be recognized in CET1 (an effect known as "add-back") in full in 2020 and 2021, reducing the percentage of recognition progressively and proportionately over the following three years (75% in 2022, 50% in 2023 and 25% in 2024).

The amendments introduced also ease the possibility for entities to use this transitorial arrangements (so as to avoid that it is limited solely to those entities that had previously decided to apply it).

— **Adjustments related to the temporary exclusion of central bank reserves from the leverage ratio**[6] — this amendment aims to permit the exclusion of central bank reserves from the denominator of this ratio when the competent authority, after consultation with the relevant central bank, declares that exceptional circumstances exist, warranting its exclusion in order to facilitate the implementation of monetary policies.

The adjustments introduced serve two main purposes. First, for the purposes of supervisory reporting and disclosure of information to the market, the exclusion may be applied until June 2021 (the leverage ratio is not introduced as a minimum requirement until that date and, accordingly, the exclusion will not give rise to direct effects on capital requirements until then).

Second, the calibration currently required to introduce this exemption (already envisaged in the CRR) is amended. The prior method established in the CRR offset any type of benefit obtained from the exemption, with the aim of preventing the release of capital as a result of its application. This exception becomes operational with this amendment, preventing that effect and, therefore, allowing for increases in central bank reserves not to affect banks' leverage ratios.

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1 Regulation (EU) 575/2013 and Regulation (EU) 2019/876.

2 Also amended was the treatment of credit risk for exposures to central banks and central governments denominated in the domestic currency of another Member State, to reintroduce a favourable temporary treatment within the framework of large exposure limits and credit risk (risk-weighting of exposures).

3 Entities have the option of reversing this treatment once during the transitional period.

4 Treated as sovereign exposure under Articles 115.2 and 116.4, with the exception of non-performing financial assets.

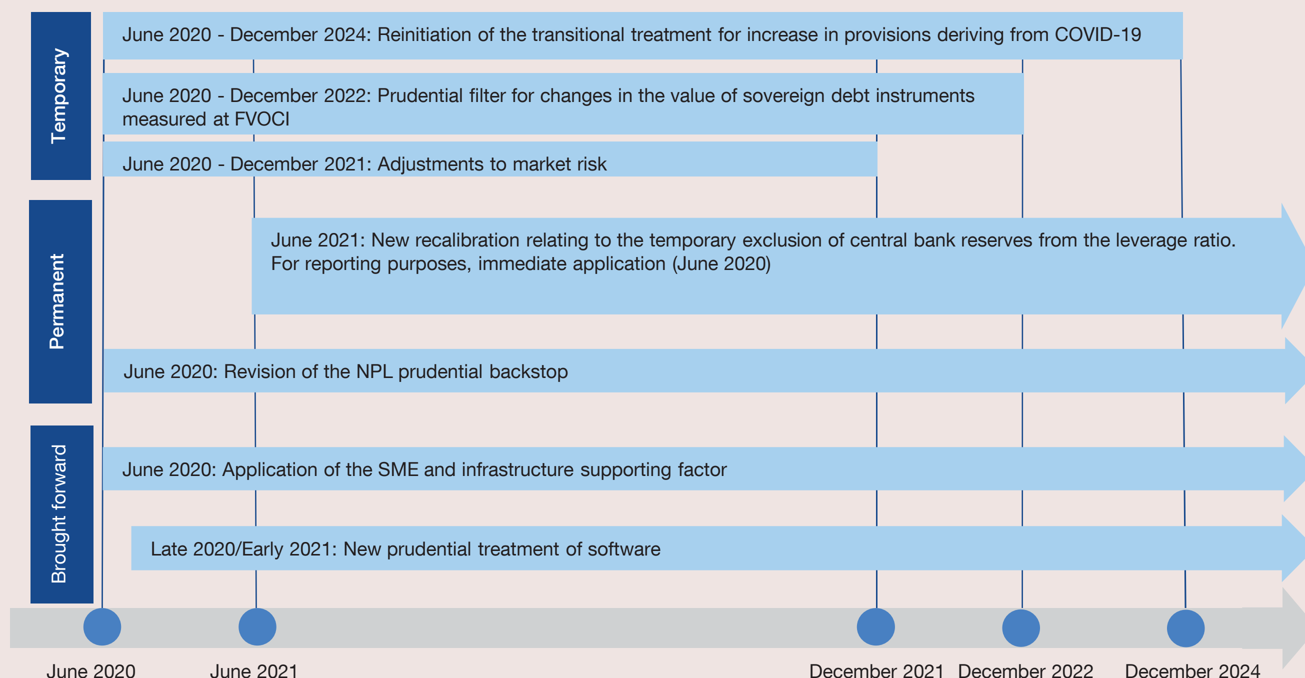
5 Treatment of the static component (increase in provisions arising from the first time application of IFRS 9) remains unchanged. The change in the dynamic component prior to 2020 (differential increase in the stock of provisions in Stage 1 and Stage 2 from 1 January 2018 to 31 December 2019) will be subject to the existing transitional arrangements only if this involves a benefit for the entity.

6 It is also agreed to defer the entry into force of the leverage ratio buffer for G-SIBs until 2023, in line with the one-year deferral agreed at international level on the implementation of the 2017 Basel III standards: Finalising post-crisis reforms.

Box 3.3
AMENDMENTS TO EUROPEAN BANKING REGULATION IN RESPONSE TO THE COVID-19 PANDEMIC (THE CRR QUICK FIX) (cont'd)

Figure 1

TIMELINE AND DURATION OF QUICK FIX REFORMS



SOURCE: Banco de España.

— **Revision of the NPL prudential backstop** – as regards the calculation of the deduction for insufficient provisioning for NPLs, the application of a 0% factor on the part guaranteed by public sector government is introduced on a permanent basis. This treatment is applicable during the first seven years since the exposure is classified as non-performing.

— **Adjustments to market risk requirements** – supervisors are granted discretionary powers to decide whether, under exceptional circumstances and on a case-by-case basis, institutions may exclude from the calculation of market risk requirements the overshootings deriving from the institutions' internal models and arising between 1 January 2020 and 31 December 2021, provided they do not arise from shortcomings of the internal model.

— **Bringing forward of measures scheduled for 2021, including:**

— **Software deduction** – the entry into force of the new prudential treatment of software is brought forward. The European Banking Authority (EBA) was responsible of tne development of the new treatment through a regulatory technical standard (RTS).[7] The quick fix amendment establishes its application from the entry into force of the RTS, instead of 12 months later, as was originally envisaged. To date, all intangible assets of institutions, including software, were deducted from CET1. Accordingly, this amendment will have an immediate impact on the highest-quality capital of institutions.

7 See "Final draft RTS on prudential treatment of software assets", EBA 14/10/2020.

Box 3.3

AMENDMENTS TO EUROPEAN BANKING REGULATION IN RESPONSE TO THE COVID-19 PANDEMIC (THE CRR QUICK FIX) (cont'd)

— **SME and infrastructure supporting factor** – the application date is brought forward to 27 June 2020. Exposures to SMEs below €2.5 million will apply a factor of 0.7619 in calculating their risk weight, while those exceeding such amount will be weighted factored at 0.85.[8] The supporting factor for exposures to entities that operate or finance infrastructures or support essential public services will be 0.75, provided certain criteria are met. These amendments reduce risk-weighted assets, therefore raising the solvency ratios.

The purpose of this set of measures is to introduce a favourable prudential treatment with the aim of supporting the flow of credit to households and businesses. Its impact in terms of capital will depend on the types of exposures and the balance sheet movements (provisions, changes in fair value, etc.) involved. In any case, it is expected to result in an increase in the prudential solvency ratios.

8 The CRR II introduced the infrastructure supporting factor and also expanded the scope of the already existing SME supporting factor (specifically, a scaling factor of 0.7619 was applied under the CRR, reducing the capital requirements for credit risk to exposures to SMEs, provided they did not exceed €1.5 million).