Track Changes

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WOLF THEISS

THE IMPACT OF COVID-19 ON THE REGULATORY ENVIRONMENT FOR BANKS

EUROPEAN EFFORTS TO PREVENT THE CRISIS FROM SPREADING TO BANKS

The worldwide health crisis triggered by COVID-19 resulted in a tremendous economic crisis, most likely one of the largest ever – as it not only affects nearly all continents and countries, but also nearly the entire economy. While the current crisis is not yet a banking crisis, European legislators and regulators have taken many steps to avoid this from turning into one. Top of their list is avoiding a liquidity shortfall, an increase in non-performing loans and additional capital requirements. While measures they are putting in place are aimed at tackling these issues, it remains to be seen whether it will be enough to achieve this goal.

> "*Unlike in the 2008 financial crisis, banks are not the source of the problem this time. But we need to ensure that they can be part of the solution.*" Andrea Enria, Chair of the ECB Supervisory Board

Also unlike the financial crisis, all of the main business areas of the "real economy" (industry as well as the services sector) are suffering from the pandemic. However, **the current global crisis is not (or at least not yet) a banking crisis**. This seems to be one of the main messages of the European regulators when they are repeatedly pointing out that the European banks are better prepared than before the financial crisis – of course not without ulterior motives:

- On the one hand, European banks play a major role in implementing the measures undertaken by European governments against the negative economic effects of the COVID-19 pandemic: this is particularly true for credit moratoria (either statutory or voluntary) as well as (fully or partly) state guaranteed loans to SMEs and corporates which are common instruments used by many EU countries.

- On the other hand, it is necessary that the banks remain stable.

For this reason, both the European legislator(s) as well as European regulators are doing everything they can in order **to avoid a further banking crisis in the future**. The measures address the main risks for banks/the regulators' concerns, i.e. a **liquidity shortfall** (*inter alia*, as a consequence of the credit moratoria, withdrawal of deposits and limited access

to functioning capital markets) and **an increase of non-performing loans** resulting in higher capital requirements and leverage ratios.

Measures on a European level by the ECB are aimed at:

- **Helping the economy absorb the shock through asset purchases and long-term loans to banks**: To support the economy in the crisis, the European Central Bank (ECB) - Eurosystem has launched a package of monetary policy measures, such as the EUR 1,350 billion pandemic emergency purchase programme (PEPP).
- **Ensuring firms and households have access to credit & helping banks focus on providing vital funding to the economy**: On 12 March 2020, the ECB – Banking Supervision announced the following "*temporary capital and operational relief in reaction to coronavirus*":

    - banks can fully use capital and liquidity buffers, including Pillar 2 guidance (P2G);

    - banks will benefit from relief in the composition of capital for Pillar 2 requirements (P2R); and

    - ECB to consider operational flexibility in the implementation of bank-specific supervisory measures.

- **Encouraging banks to do their share**: On 27 March 2020, the ECB recommended not to pay dividends for 2019 and 2020, at least until 01 October 2020 or buy back shares during the COVID-19 pandemic.
- **Reducing banks' risks and increasing their lending capacity:** To avoid a situation where a bank is short of funds because more loans to such customers are being classified as "non-performing", banks now have more flexibility when they are classifying loans that are backed by public guarantees. The ECB is also less strict about how much banks must put aside to prepare for losses on government-backed loans. This further frees up capital for loans to households and companies.

In addition, on 09 June 2020, "*with a view to striking a balance between a robust and stable banking system and securing much-needed credit for the EU economy*", **the European Parliament has agreed to apply specific changes to the capital requirements regulation (CRR)** which will have to be coherently applied in the EU. The new rules – to temporarily ensure favorable conditions for banks in order to support credit flows to companies and households and absorb losses, mitigating the severe economic consequences of the COVID-19 pandemic and resulting quarantine – include:

- extension by two years of transitional arrangements for IFRS 9 and further relief measures (capital add back);

- alignment of minimum coverage requirements for non-performing loans guaranteed by the public sector with those guaranteed by official export credit agencies;

- deferred application of the leverage ratio by one year (to January 2023);

- advanced application of both, the SME and infrastructure supporting factors, which allows for a more favorable prudential treatment of certain exposures to SMEs and infrastructure, ensuring credit flow to SMEs and supporting infrastructure investments;

- deduction of certain software assets no longer applicable (for supporting an accelerated digitalization of the banking sector);

- reintroduction of transitional arrangements regarding preferential treatment for when governments and central banks are exposed to bonds denominated in currencies of non-Euro Member States and prolongation of transitional arrangements regarding their treatment under large exposure limits;

- temporary prudential filter to calculate losses accumulated since 31 December 2019 and to neutralise their impact.

Also the Single Resolution Board (SRB) has announced certain actions in response to the COVID-19 pandemic.

The European Banking Authority (EBA) has stated that it supports the measures taken and proposed by national governments and EU bodies to address and mitigate the adverse systemic economic impact of COVID-19 on the EU banking sector. Similarly, national competent authorities, such as the Austrian Financial Market Authority (*Finanzmarktaufsichtsbehörde* – FMA), have committed themselves to adhere to these measures.

OUTLOOK

It remains to be seen whether the "temporary measures" with a "preventive nature" are sufficient to achieve their goal – i.e. obviously to avoid a new banking crisis.

What is more is that, despite (or because of) the crisis, at least the European regulators are working on issues which have been "hot topics" for European politicians (keyword: "Green Deal", etc.), but have "cooled down" during the COVID-19 pandemic. This is in particular true for issues such as climate change, sustainability and environmental, social and governance (ESG) criteria in general.

Last, but not least, the current situation in the capital markets resulted in lower share prices – also for banks (even if not primarily affected by the economic crisis). This could be interesting for a number of investors and could lead to (hostile) take-overs or consolidation in the banking sector.

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For more information about our services, please contact:

Christine Siegl
Counsel
christine.siegl@wolftheiss.com
T: +43 1 51510 5064

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Wolf Theiss
Schubertring 6
AT – 1010 Vienna

www.wolftheiss.com