MONETARY AND CAPITAL MARKETS

Special Series on COVID-19

The Special Series notes are produced by IMF experts to help members address the economic effects of COVID-19. The views expressed in these notes are those of the author(s) and do not necessarily represent the views of the IMF, its Executive Board, or IMF management.

Banking Sector Regulatory and Supervisory Response to Deal with Coronavirus Impact (with Q and A)[1]

This note provides MCM views on the appropriate regulatory and supervisory response to deal with the impact of the Coronavirus pandemic that can maintain the balance between preserving financial stability, maintaining banking system soundness and sustaining economic activity. Post-GFC banking regulation aims to protect the interest of depositors and preserve financial stability. Relaxing these minimum standards can jeopardize these objectives and precipitate further financial instability. Many supervisors have developed an approach to dealing with such large-scale disasters through guidance built around prudent renegotiation of loan terms without lowering loan classification and provisioning standards. Banks' existing buffers should be used first to absorb the impact of the crisis. In cases where the impact is much wider and/or longer lasting and banks' capital adequacy is compromised, supervisors should take targeted actions, including asking banks to submit a credible capital restoration plan and monitoring its execution. In such cases, governments may also choose to step in with fiscal support to aid borrowers to repay their loans and finance their operations or to help banks absorb the implications of the crisis. Throughout this process, transparent risk disclosures and supervisory expectations on dealing with the implications of the outbreak will be important for market discipline to work effectively.

I. INTRODUCTION

COVID-19 is taking a toll on economies and banking systems across the world, particularly in hard hit countries so far. The highest impact on banks is related to their loan portfolios where many borrowers across different sectors are facing sharp collapse in their income, and hence difficulty in repaying their obligations as they come due. Many regulatory and supervisory authorities have issued statements or guidelines to banks on how to deal with the impact of the outbreak, including in relation to easing loan terms and conditions for impacted borrowers and sectors. This note aims to provide some broad policy views on the appropriate regulatory and supervisory response to deal with the impact of COVID-19. Additional clarifications are included

[1] For more information, country authorities may contact Nigel Jenkinson (njenkinson@IMF.org), Division Chief of the Financial Supervision and Regulation Division of the Monetary and Capital Markets Department (MCMFR).

in the form of questions and answers (Annex 1), including tables comparing prudential, accounting, and regulatory reporting frameworks (Annexes 2 and 3).

Supervisors and regulators should play an integral part and contribute to public policy responses to the COVID-19 pandemic. Consistent with their mandate of ensuring safety and soundness, supervisors' action requires a balancing act in which banks are encouraged to restructure loans and use the flexibility embedded in the prudential framework to continue financing viable firms and, at the same time, the confidence in the banking system is maintained by ensuring that losses are not hidden and prudential standards are not relaxed.

Countries need to be prepared: the economic impact of the coronavirus will affect borrowers' capacity to service loans, and banks' earnings will suffer. Governments should not encourage unsound practices or provide blanket relaxation of standards. It is important that any government policy which allocates resources to assist distressed borrowers—or banks—is transparent, targeted, and clearly temporary, so as not to create moral hazard and foster poor credit risk management practices.

In previous events, countries have employed various mechanisms to relieve the impact and sustain economic activity. These include: (i) a range of financial and fiscal measures to support distressed sectors or borrowers (e.g., direct measures such as tax cuts and subsidies to corporates and households that are the most affected, and indirect measures like credit guarantee schemes and subsidized bank lending arrangements); (ii) measures to alleviate the strains on the banking system (special liquidity lines, blanket guarantees for liabilities, etc.); and (iii) monetary stimulus to support economic activity and maintain adequate liquidity levels in the financial system. This note does not discuss the adequacy of these various mechanisms and their implications, since the choice and combination of the most appropriate measures will depend on specific country circumstances.

II. DEALING WITH BORROWERS

Banks should work constructively with affected borrowers and supervisors should encourage prudent loan restructuring where necessary to sectors or firms heavily impacted by the crisis. It is important to note that the restructuring decision is a business decision by the bank, based on the assessment of the borrower's capacity to pay under the new terms. Banks should not be encouraged to foreclose loans, cease and liquidate collateral, using out-of-court mechanisms and/or legal proceedings. Instead, restructuring could take the form of renegotiated terms (maturity, interest rates, fees), moratorium policies or grace periods/payment deferrals.[2] A grace period to repay loans could help borrowers manage the temporary impact of the crisis. These types of measures fall under loan restructuring, which is a standard practice when borrowers face temporary difficulties (due to natural disasters, economic shocks, sectoral difficulties, etc.). The Basel framework, as well the 2017 Guidelines on the Prudential Treatment of Problem Assets—Definition of Nonperforming Exposures and Forbearance provide a useful international framework for dealing with loan restructuring cases. Furthermore, IFRS 9 describes the accounting implications of modification in loan terms and conditions. In addition to payment deferrals extended by banks on a case by case basis as they would normally do when borrowers are facing short-term payment challenges, general payment moratoria based on a specific legislation and/or implemented through sector-wide private initiatives have been introduced in several jurisdictions. While providing relief to affected borrowers, moratoria may raise certain issues. Among other

[2] Many jurisdictions (for example, Hong Kong SAR and Singapore) have recently issued communications to their banks encouraging them to pursue temporary relief measures for their borrowers, such as principal moratorium or extension of payment terms, in line with existing guidelines.

things, it is essential to minimize moral hazard issues by ensuring that: (i) borrowers that were already highly unlikely to repay before the COVID-19 crisis started do not unduly benefit from wide-ranging repayment holidays, and (ii) borrowers facing temporary difficulties are not disincentivized to resume loan repayment at the end of the application of the moratorium. Several accompanying measures should therefore be considered. In particular, banks and supervisors should continue monitoring credit portfolios for signs of distress.

From a prudential perspective, banks should follow certain requirements related to restructured loans, using the flexibility embedded in the regulatory framework. In restructuring currently performing loans impacted by the outbreak, banks should assess the capacity of repayment and performance of the loan under the revised terms and classify the loan as forborne, if needed. In a recent statement, the Basel Committee issued some clarifications on dealing with payment moratoria, and indicated that borrowers' acceptance of a general payment moratorium or access to other relief measures such as public guarantees should not automatically lead to the loan being categorized as forborne.[3] When loan modifications meet the definition of forbearance, the classification as forborne loans should continue for a probation period of one year (at a minimum) during which the loans should be closely monitored and reassessed accordingly.[4] If the restructuring results in little impact on the net present value of the exposure, which is typically the case when payment deferrals are introduced, the borrower would not be classified as defaulted in the prudential sense.

Irrespective of whether the loans are restructured or not, banks may at some point face losses on their loan portfolios due the impact of the crisis. Whether restructured or not, loans could become non-performing and would require provisioning. Depending on the terms of the restructuring, the amount of provisions might be small (for example, if only the interest rate is reduced). Some performing loans may also require higher provisioning due to a significant increase in credit risk, which would require a different level of Expected Credit Losses (ECL) estimates.[5] The overall impact will depend on the severity and spread of the COVID-19 pandemic as well as the magnitude of the economic and financial impact on the bank.

Loan classification and provisioning rules should not be relaxed. It is critical to measure nonperforming exposures (NPEs) and potential losses as accurately as possible. Banks should not be encouraged to hide losses (creating moral hazard and transparency issues). Further, public authorities and supervisors need to rely on accurate data (losses, capital shortfall) to take appropriate decisions. The status of the exposures (performing vs. nonperforming) and the level of provisioning should be reassessed on a regular basis to account for the evolution of the situation. The unprecedented uncertainty about the impact on economic activity poses challenges to the reliable estimation of credit losses. Supervisors should not rush banks to produce these estimates. They should provide guidance on how to assess the impact of the COVID-19 pandemic on provisions reflecting the nature of the shock (likely short-term) and the relief measures granted by public authorities.

---

[3] BCBS, guidance on Measures to Reflect the Impact of COVID-19, April 2020.

[4] The use by banks and supervisors of the internationally agreed definitions of forborne and non-performing exposures is important for monitoring and assessing banks' asset quality in a consistent manner, both within and across jurisdictions, and facilitates timely action to address rising asset quality problems. A forborne loan is one where the borrower is in financial difficulty and the bank grants concessions that would not be considered under normal market conditions. Nonperforming exposures are all exposures that: (i) are "defaulted" under the Basel framework; (ii) are credit-impaired according to the applicable accounting framework; (iii) are not defaulted or impaired but nevertheless: (a) are more than 90 days past due; or (b) there is evidence that full repayment based on the contractual terms, original or, when applicable, modified is unlikely without the bank's realization of collateral.

[5] IFRS 9 requires reporting entities to assess credit risk and measure ECL based on a probability weighted amount, resulting from evaluating a range of possible outcomes. The process includes deciding whether there has been a significant increase of credit risk and estimating lifetime ECL.

Additional financing or extending further credit to impacted firms could be part of the loan restructuring process but should be in line with prudent risk management principles. Providing additional financing to firms should be based on the firms' ability to repay and should not lead to relaxation of underwriting standards. Supervisors should review substantial changes in loan practices and assess whether these activities are consistent with the bank's credit policies and risk profile, while taking into consideration credit enhancements that might be provided (e.g., credit guarantees provided by public sector entities).

III. DEALING WITH THE IMPACT OF THE OUTBREAK ON BANKS' FINANCIAL POSITION

Capital buffers should be used first. As outlined earlier, banks will be facing losses due to the impact of the outbreak on the quality of their assets. Banks should first draw down on their capital conservation buffer (CCB). In that case, it is however important for the supervisor to ensure that dividend distribution planning is revised accordingly. When already activated, Countercyclical Capital Buffers (CCyB) may be also released.[6]

Liquidity buffers should also be used, if needed. The impact of the outbreak could affect bank's funding and liquidity positions (i.e., clients may withdraw their deposits), which may lead banks to fall below LCR thresholds. In accordance with Basel LCR standard, banks may use their stock of HQLA during a stress period thereby falling below 100 percent, as maintaining the LCR at 100 percent under such circumstances could produce undue negative effects on the bank and other market participants. Supervisors should subsequently assess this situation and adjust their response depending on the magnitude and duration of the shortfall. Enhanced supervisory reporting could be introduced. Potential measures to restore liquidity levels should be discussed and executed over a period of time considered appropriate to prevent additional stress on the bank and on the financial system as a whole.

In countries where banks' capital requirements are significantly above international standards, there may be space to make adjustments. Several Emerging Markets and Developing Economies (EMDEs) have not implemented Basel III and therefore have no CCB. However, many of these jurisdictions have additional capital buffers in the form of higher risk weights or capital requirements substantially above international standards. To the extent that these additional requirements are not only the reflection of additional risks faced by banks such as challenges to enforce collateral or high volatility, but also have a macro-financial nature (and considered a tool to manage external shocks), a temporary relaxation could be considered. Generally, these countries may have greater flexibility in the design of banks' capital restoration plans which could rely more on tools such as restrictions on dividend distribution and bonus payments when a bank's capital falls below the country's minimum requirements (Annex 1).

Supervisors should thoroughly assess the impact of market volatility on banks' earnings and capital, and carefully design their response taking into account flexibility in existing rules while maintaining confidence in the banking system. Risk-sensitive capital requirements based on internal Value-at-Risk (VaR) models and stressed VaR models have increased as a result of extreme market volatility, which has led to increased model back-testing exceptions. Supervisors should thoroughly monitor back-testing exceptions, analyze their reasons, and stand ready to challenge banks on those exceptions and require models' adjustments where necessary. The sharp fall in assets' market prices has also left adverse implications on banks' earnings and capital. Supervisors should ensure that mark-to-market relief measures and practices

[6] For example, the Bank of England announced on March 11 that it would cut banks' counter-cyclical capital buffer requirement from one percent to zero.

remain in line with accounting requirements and continue to promote confidence in the banking sector (rather than hiding market valuation losses).

IV. SUPERVISORY APPROACH

Supervisors may need to address cases where a bank's capital position is materially compromised by losses derived from the impact of the virus. Due to the outbreak, the amount of nonperforming exposures and related losses could significantly increase, which could materially impact a bank's capital adequacy position. Initiating resolution in such cases during the onset of the pandemic is not advisable. Instead, targeted and temporary supervisory actions, as described below, can be contemplated in these exceptional cases, so long as loan classification and provisioning rules continue to be fully applied. In addition, supervisors should consider suspending discretionary capital distributions by banks and financial institutions to ensure that capital resources are maintained to support the economy and absorb losses as a priority. Finally, if warranted by banks' profile and systemic importance, supervisors should review and require banks to enhance their recovery plans, as needed, in light of challenges posed by the pandemic.

Supervisory authorities may wish to temporarily reconsider automatic triggers of corrective measures, in favor of discretionary, risk-based approaches aimed at maintaining long-term financial stability. The fall in the capital adequacy ratios below certain thresholds may automatically trigger, in some countries, the activation of corrective actions or resolution mechanisms. To the extent that the legal framework provides the necessary flexibility, supervisors may wish to temporarily reconsider the automatic activation of corrective measures. However, as the crisis subsides and its impact becomes clearer, banks should submit a feasible medium-term capital restoration plan that provides for capital augmentation in a gradual way, taking into account any remaining market uncertainty and banks' ability to raise capital in such an environment. A close supervisory monitoring would ensure that the bank is satisfactorily meeting its capital targets, while maintaining a fundamentally sound financial condition, and that the decline in regulatory capital ratios would be temporary. In the case of a longer-term impact with major systemic implications, supervisors are encouraged to work with governments as additional actions may need to be considered to support the financial system.

Supervisory policies, as any crisis-related measures, should be well tailored and targeted to problems caused by the crisis and not to issues attributable to pre-existing vulnerabilities. It is key that governments avoid blanket relief measures that create opportunities for moral hazard and foster poor credit risk management practices. Supervisors should provide banks with guidance on the prudential implications of official measures enacted to support borrowers while ensuring that banks continue to assess the credit quality of exposures subject to these measures. In addition, supervisory policies and actions (included those related to capital) should only be targeted to problems created by the crisis and not to unrelated issues that could be due to bad bank governance and management. For banks that were close to resolution before the crisis, a case-by-case assessment should be made on whether resolution could proceed and, if so, how. Banks that were failing before the pandemic should still be resolved, if it can be done effectively (e.g., in countries that are yet to experience the worst of the pandemic). If operational challenges are too high and banks whose failure would be systemic cannot be resolved immediately, authorities should be careful that managers cannot in the interim "gamble for resurrection" or commit fraud and "asset stripping".

Supervisory authorities should provide guidance on using the flexibility embedded in regulations. A blanket reduction or suspension of micro-prudential prudential and accounting would only incentivize excessive risk taking and encourage banks to hide poor underwriting practices. It will not solve the underlying problem. Banking regulation has positive effects both in normal times and under stressful conditions. Supervisors should provide clarity and guide banks on the various elements of flexibility embedded in banking regulation. Such flexibility includes using capital and liquidity buffers, relaxation of some macroprudential measures (where decided by the national macroprudential authority), [7] and dealing with prudential loan restructuring practices or with government-announced targeted loan moratoria.

Communication and transparency are essential. A clear communication of supervisory expectations about banks' response to distressed borrowers and the regulatory approach in dealing with the temporary impact of the outbreak is essential. Enhanced reporting, including within banks, between banks (through credit registries and bureaus, if possible), and to supervisors, is needed. It would also be helpful to identify, quantify, and report forborne loans, and to introduce strict criteria for acceptable loan restructuring. Banks are also expected to conduct portfolio reviews and risk assessments on a regular basis to measure the impact of COVID-19 on their financial conditions. Engagement between banks and banking supervisors should also be enhanced, particularly in the midst of the crisis where banks' regular disclosures may not fully reflect the magnitude of the shock. Supervisors may need to take quick actions to address market concerns and stress. Supervisors are recommended to quickly introduce ad-hoc reporting of stock and flows specifically for affected loans so that financial stability implications can be more accurately assessed as the situation evolves. In addition, transparent banks' public disclosures are key to provide the public with a true picture of the bank's financial position and to inform supervisors about the measures needed to deal with the implications of the outbreak.

[7] The use of macroprudential buffers, including the release of the CCyB and the relaxation of other macroprudential measures (systemic risk buffers, sectoral capital requirements, borrower-based measures such as loan-to-value limits), could be considered as a potential response to the crisis. A relaxation of macroprudential tools can mitigate the impact of the shock on credit and help ease a credit crunch that amplifies the effect on the real economy. However, such a relaxation is possible only if macroprudential buffers are in place.

ANNEX 1. Questions and Answers (Q&A)

General Prudential and Supervisory Considerations

1) What could supervisors and regulators do to encourage banks to maintain the flow of credit to the economy and mitigate financial risks to the banking system?

2) Why don't supervisors simply relax or even suspend prudential and accounting rules to avoid a banking crisis and ensure that banks continue to support borrowers?

Dealing with loan restructuring and loan classification and provisioning

3) How should banks and supervisors factor the uncertainty generated by the coronavirus in their assessment of the deterioration of the creditworthiness of borrowers?

4) How should supervisors deal with blanket restructuring approaches, given the scale of the problems and banks' inability to quickly restructure loans on individual bases?

5) What is the difference between loan restructuring and loan forbearance?

6) Should jurisdictions which set stricter prudential loan loss provisioning requirements (than required by accounting standards) consider relaxing these?

7) What are the prudential considerations regarding debt moratoria?

Prudential Considerations—Capital, Liquidity, and Market Risk Requirements

8) What approach should be considered for countries that have not adopted Basel III standards and may not have capital and liquidity buffers designed to absorb the impact of a crisis?

9) What if banks do not have sufficient capital buffers to absorb the losses associated with the crisis?

10) How to deal with countries where banking systems do not have capital buffers to absorb the impact of the crisis and there is limited fiscal space to provide additional government support?

11) How supervisors should address the implications of higher market volatility and the sharp fall of asset prices created by the pandemic?

12) When banks are applying the internal model approach to market risk, should supervisors introduce measures to mitigate the volatility-induced pro-cyclicality of capital requirements?

IFRS Considerations

13) Should applying IFRS 9 ECL requirements take into account the current development related to COVID-19?

1. What could supervisors and regulators do to encourage banks to maintain the flow of credit to the economy and mitigate financial risks to the banking system?

- **Regulatory and supervisory actions should aim to support the provision of credit while maintaining prudent underwriting standards and confidence in the banking system, mitigating financial risks, and ensuring institutions can operate effectively.** Considering the short-term uncertainty and the potentially acute impact of the coronavirus on economic activity, supervisors should:
  - **Encourage banks to restructure loans**. By providing a grace period or adjusting the terms of the contract, banks can help borrowers manage the temporary impact of the virus on their business and minimize their own losses. If the net present values of the contracts are not meaningfully reduced, exposures may not necessarily be classified as nonperforming.[1] In ideal circumstances, banks would assess repayment capacity using updated borrower information before temporary restructuring were granted. However, the acute nature of the crisis might require the restructuring of many loans and banks' operational capacity to diligently re-underwrite a large volume of loans will be limited. Given the urgency and widespread impact, more systematic approaches may be needed but, at a minimum, banks should apply eligibility criteria (targeting specific types of debtors/sectors hit by the crisis), credit scoring (even if highly simplified), and timebound criteria for acceptable loan restructuring. Depending on the nature of the restructuring and the situation of borrowers, banks may be required to classify the loans as forborne and monitor performance under the revised loan terms (Annex 2 and questions 2, 4, and 5).
  - **Communicate supervisory expectations about assessing the creditworthiness of borrowers.** The unprecedented uncertainty about the impact of the virus on economic activity poses challenges to the reliable estimation of credit losses. Supervisors should not rush banks to produce these estimates. Supervisors should communicate their expectations about the shock (question 3) and how measures to support the economy should be factored into asset classification, provisioning (Annex 3).
  - **Provide banks with guidance on the prudential implications of official measures to support borrowers**. Some jurisdictions have enacted measures to support borrowers during the crisis, such as debt moratoria / repayment holidays and credit guarantees to some sectors or types of loans. Loan classification processes should take into account the implications of repayment holidays / debt moratoria (questions 4 and 7). Credit guarantees will typically have a favorable impact on the estimation of loan losses, provisioning, and prudential capital requirements. Consistent with international standards, for loans that are subject to sovereign guarantees, the relevant sovereign risk weight should be assigned to the exposure covered by the guarantee to determine a bank's credit risk capital requirement (to the extent that transactions are denominated in local currency). The existence of any credit risk mitigation should not exempt banks from performing the assessment of the borrower's unlikeliness to pay. This applies to any guarantees -including public guarantees offered in response to the COVID-19 pandemic. While the guarantee may limit the losses for the bank should the borrower default, it does not affect the payment capabilities of the borrower.
  - **Issue public statements emphasizing the usability of capital and liquidity buffers.** The Basel III framework (which has been introduced in many countries) created capital buffers (e.g., capital conservation buffer; CCyB; and G- and D-SIBs buffer) and liquidity buffers (e.g., liquidity coverage ratio) that were designed to be used in case of adverse shocks.[8] Some jurisdictions have additional capital buffers as well. Supervisors should consider issuing public statements outlining the nature of these buffers and their

[1] Similar considerations can apply to additional LCR requirements in significant foreign currencies that are in use in a number of countries in addition to the Basel ratios.

availability to be used during crisis times. Along the same line, jurisdictions that have set the CCyB above zero should consider its release, as well as the relaxation of other macroprudential measures depending on the objectives of those measures and country-specific circumstances (systemic risk buffers, sectoral capital requirements, loan-to-value limits).

- **Limit imprudent capital distributions (e.g., dividend payouts, share buybacks, bonus payments).** At the current stage, the potential impact of the COVID-19 epidemic on the financial sector is highly uncertain. Initial estimates, however, suggest that the potential impact may be substantially higher than the stress test scenarios used by most supervisory authorities to assess the capital adequacy of financial institutions. In this context, to ensure that the banking sector continues financing the real economy and has enough resources to absorb losses, it is recommended on grounds of prudence that supervisory authorities take actions to preserve banks' capital resources by temporarily suspending the distribution of capital (dividends, share buybacks and discretionary bonus payments) for all banks, until the impact of the pandemic becomes clearer.

- **Review supervisory priorities.** Supervisors should refocus their priorities and emphasize risks and areas more heavily impacted by the crisis including banks' liquidity profile, credit risk exposures to vulnerable sectors and operational resilience. During this period, supervisory authorities should issue more guidance on their expectations and increase monitoring and engagements with banks on relevant risks and priorities, including asset quality, funding / liquidity, capital etc. At the same time, supervisors should consider postponing resource intensive activities such as routine stress testing /onsite inspections, that might be less relevant in the current context and would divert banks' management from more pressing tasks.

- **Extend implementation timeline and consider targeted transitional arrangements.** Regulators should also consider adjusting phase-in periods of new prudential requirements in a coordinated and consistent manner using appropriate international fora. For example, in light of the uncertainty arising from the COVID-19 crisis and its impact on economic losses, the Basel Committee on Banking Supervision (BCBS) has recently decided to extend the timeline for the implementation of outstanding Basel III standards. The BCBS has also adjusted transitional arrangements to smooth the impact of ECL accounting on regulatory capital. In that case, appropriate disclosures requirements should be introduced (impact of transitional arrangements on banks; capital).

- **Take timely corrective action to address weak banks.** Maintaining the confidence in the banking system is key to avoid market uncertainty and ensure appropriate functioning of financial markets. Market participants should be able to differentiate banks that are sound from weak ones. In that regard, supervisory authorities should take timely and appropriate actions to restore banks viability and capital buffers (questions 9 and 10).

- **Coordinate policy responses and measures domestically and internationally.** On the domestic front, it is key to coordinate the financial sector policy response with the relevant agencies and authorities that are in charge of preserving financial stability using existing institutional arrangements. Given the global nature of the crisis, it is also important to liaise internationally (either through standard setting bodies or via multilateral groups or cooperation arrangements) to ensure that policy responses are well coordinated and preserve global financial stability.

2. Why don't supervisors simply relax or even suspend prudential and accounting rules to avoid a banking crisis and ensure that banks continue to support borrowers?

- **Transparency and accuracy of data are important to maintain the confidence in the banking sector.** Banking crises are often characterized by a sudden loss of trust between banks, market participants and depositors. Past crisis experience shows that transparency is a precondition for maintaining trust in the system. Accurate and reliable information (amount of NPLs, potential losses, capital shortfalls) is essential for managing risks in the balance sheet over short and long terms and for public authorities to formulate the most appropriate policy responses. The authorities need to be able to rely on the existing monitoring tools, as they might not have enough time or operational capacity to conduct in-depth asset quality reviews in a large number of institutions to identify the weak banks and quantify the losses. Relaxing loan classification and provisioning rules would adversely impact transparency and data reliability, as financial statements and prudential ratios would no longer adequately reflect the truth. Without reliable information, the market, the public and the authorities cannot distinguish weak banks from sound banks, which could lead to a wider loss of confidence in the entire banking system, with adverse implications for stability. Reliable data is also crucial if supervisors need to work with governments on additional actions to support the financial system, in the case of a longer-term impact with systemic implications.
- **Existing prudential rules provide flexibility to deal with a crisis situation.** Banks should work constructively with affected borrowers. Restructuring a loan does not necessarily imply that the borrower will be reclassified as defaulted and the transaction considered as nonperforming. And even if exposures were reclassified as non-performing, this does not mean that the level of provisioning would increase immediately. Provisions are likely to be recorded gradually, as banks assess the impact of the COVID-19 outbreak on borrowers' ability to meet their obligations and the impact on each business becomes clearer. The wholesale relaxation or the suspension of accounting rules would not make losses disappear, and simply hiding them on banks' balance sheets would risk the health and stability of the banking system.
- **The announcement of extreme policy measures such as sudden changes to relax accounting rules may generate market concerns and impact confidence.** In many countries, for the time being, banks are seen as strong and well capitalized institutions. Relaxing accounting rules might undermine this view and raise concerns that the real soundness of the banking sector is worse than the one conveyed by official authorities.

3. How should banks and supervisors factor the uncertainty generated by the coronavirus in their assessment of the deterioration of the creditworthiness of borrowers?

- **While uncertainty about credit risk is not new to banks and supervisors, the range of scenarios that might result from the coronavirus and their potential impact on borrowers is unprecedently wide, particularly in the short-term.** This might generate a substantial dispersion of practices across banks.
- **When limited information is available, supervisors should provide banks enough time to assess whether borrowers are able to meet their obligations.** The unprecedented uncertainty about the impact of the coronavirus will challenge banks to produce reliable forecasts of likely credit losses for different kinds of businesses.
- **To the extent possible, supervisors should convey their expectation about how different scenarios should be considered by banks when assessing the creditworthiness of borrowers and estimating loan allowances**. Concerning loans that are impaired, the forecasted cash flows of the loan should reflect

banks' best estimate of the economic conditions that may exist over the remaining life of the asset. Given the current uncertain environment, supervisors could emphasize that expected cash-flow approaches based on probability-weighted scenarios may be more appropriate to reflect the current uncertainty than a single estimate which may misestimate the depth and length of the shock. To the extent that supervisors consider that the economic challenges are likely to be short-term, they should explain to banks and auditors their views on the range of scenarios to consider in determining expected losses, with due consideration to short-term and long-term implications. As events develop and supervisors reassess their expectations about the impact of the crisis on borrowers, regulated institutions should be appropriately informed and adjust their estimates in line with the revised scenario. Furthermore, considering the substantial economic support being provided by governments in many jurisdictions, supervisors should emphasize that they expect banks to fully take into account these measures when assessing expected credit losses.

4. How should supervisors deal with blanket restructuring approaches, given the scale of the problems and banks' inability to quickly restructure loans on individual bases?

- **Debt service moratoria have been adopted in many countries.** Given the impact of the crisis on the economy and the implications for some sectors and borrowers, some countries have announced repayment holidays and debt service moratoria, including for Small and Medium-sized Enterprises (SMEs) or on mortgage loans. These arrangements are meant to enable impacted borrowers to better weather the impact in the short-term.
- **It would be challenging for banks to reliably estimate loan losses in the short term.** Given the large scale of the restructuring that debt moratoria imply and in light of the higher priority currently attached to business continuity issues during the crisis, it is understandable that banks may not be able in the short-term to assess the implications of the crisis on their customers and their ability to pay back their obligations taking into account the effect of the debt moratorium.
- **As the outbreak subsides, banks should be in a better position to gradually assess the impact on the financial situation of borrowers, taking into account the effect of any support mechanisms provided by the government.** As banks get more certain and reliable information on the financial situation of their borrowers and their ability to repay based on the loan's modified terms, they should assess whether there is a need to change the loan classification and estimate expected loan losses. A bank may use individual or collective ECL assessment approaches depending on the way the bank manages the credit risk exposures.
- **Supervisors should review banks' loan restructuring processes and loss estimates and their implications for banks' financial and prudential situation.** Supervisors should ensure that the procedures used by a bank to measure ECL, whether determined collectively or individually, are robust and timely and take into account various criteria such as additional credit risk mitigants (such as guarantees), cash flow estimates based on assessments of macroeconomic conditions and the borrower's situation after the crisis, together with other relevant forward-looking information that affects the expected collectability of the bank's lending exposure.

5. What is the difference between loan restructuring and loan forbearance?

- **A loan restructuring (loan modification) refers to changes in the terms of the loan,** such as extending the loan terms, rescheduling the dates of principal and / or interest payments, granting additional grace periods, changing the collateral, changing interest rate and fees on the loan, etc. Such concessions (i) may be granted because the borrower is facing financial difficulties or (ii) may be commercially motivated.

- **All forbearance measures are loan modifications (concessions), but not all loan modifications are forbearance measures.** When a restructuring is considered by the bank as a concession to enable a borrower experiencing financial difficulties to meeting their financial commitments, then this would be considered a loan forbearance and the loan is considered a forborne loan. Some example of cases where the borrower is experiencing financial difficulty include: A borrower who is or is likely to be past due on its material exposures, the estimates and projections based on the borrower's current capabilities indicate that the available cash flows will not be sufficient to service the loan, credit rating of the borrower is substantially downgraded, etc. Conversely, commercial renegotiations are not forbearance measures.
- **Loan restructuring with and without forbearance are legitimate actions**. Loan forbearance is an instrument frequently used by banks to minimize credit losses. Supervisors, however, need to ensure that forborne exposures are appropriately identified and subjected to the treatment outlined in the relevant international standards (Annex 2). While supervisors should encourage banks to restructure loans and use the flexibility inherent to the accounting framework to avoid undue penalization of viable firms subject to short-term liquidity constraints, they should also maintain the confidence in the banking system by ensuring that losses are not hidden and prudential standards are not relaxed.
- **A restructuring by itself does not automatically mean that the borrower would be classified as defaulted.** Restructuring does not necessarily mean default in the prudential sense, and the transaction does not need to be considered as impaired in the accounting framework if the borrower is not in financial difficulty and/or the net present value of the loan is not reduced. The exposure would still be performing, as further explained in Annex 2.
- **Appropriate supervisory monitoring is needed**. When concessions are extended and renewed, banks should continue monitoring the borrowers' ability to repay and be ready to reclassify the exposure as nonperforming if the assessment shows that the borrower is unlikely to resume payments under the new terms of the loan facility. Several extensions of maturity 'in a row' may just signal that the borrower is basically unable to repay. Supervisors should pay attention to such practices.

6. Should jurisdictions which set prudential loan loss provisioning requirements in addition to accounting standards consider relaxing these?

- **Some jurisdictions require banks to calculate loan loss provisions according to both regulatory and accounting standards.** A common measure, for instance, is the establishment of minimum loan loss provision amounts based on the number of days that an exposure is past due. One example is in the EU where new rules introduced in 2019 require a minimum loss coverage ratio for new loans becoming NPEs depending on the number of years since classification and the level of security. Other countries also link classification and provisioning requirements with number of due past-days. In some circumstances these prudential features may generate higher provision requirements than the accounting ones. The additional provisioning is usually used to adjust (reduce) the regulatory capital ratio.
- **Supervisors should proactively provide guidance on prudential loan loss classification and provisioning requirements in view of the current crisis, without lowering requirements.** If these requirements were introduced to target specific issues (such as dealing with structural weaknesses in NPL reduction, loan recovery, and collateral valuation), they could be more gradually phased-in taking into account the additional constraints on banks and borrowers linked to the coronavirus outbreak. In this case, it is important to ensure that: (i) loan loss provisioning and the classification of exposures continue to reflect sound accounting practices and minimum international standards; and (ii) supervisors collect regular information and maintain close scrutiny over banks' asset quality and provisioning.

- **Supervisors should thoroughly analyze the nature of the official measures and provide banks with clear guidelines on the prudential implications.** Banks should regularly assess a reasonable range of scenarios in determining the impact on their asset quality, considering the high degree of uncertainty in the short run. In this respect, banks may also assess whether the operational and financial constraints of borrowers are viewed as short-term and may not jeopardize borrowers' long-term outlook (taking into account the impact of fiscal support mechanisms) once public health measures are lifted. Supervisors should require banks to make timely and granular disclosure on the criteria taken to determine loan classification and the assumptions and scenarios made in assessing the adequacy of loan loss provisions. Government decisions to provide additional financing / restructure existing loans (including through loan moratoria) should not lead, by themselves, to a different prudential treatment of loan classification and provisioning.

7. What are the prudential considerations regarding official debt moratoria?

- **Official moratoria can be a useful government tool in the face of a large exogenous shock but can give rise to moral hazard**. The moral hazard problem can be contained if the moratorium is short lived, well targeted, and transparent.

- **Imposing a debt moratorium on banks conflicts with the supervisor's safety and soundness mandate**. As an alternative to declaring official debt moratoria, supervisors could consider encouraging banks to restructure loans. By providing a grace period or adjusting the terms of the contract, banks can help borrowers manage the temporary impact of the virus on their business and minimize their own losses. Thus, it might be in banks' own interest to change the terms of the loan for borrowers that are viable in the medium-term. Because loan restructuring are commercial decisions, they tend to be more targeted and usually have substantially lower negative implications than official moratorium.

- **If government authorities consider official moratoria useful in their specific circumstances, they should consider the following elements in order to mitigate risks to financial stability:**

  - **Authorities should avoid blanket moratoria**. Depending on the specific conditions, debt moratorium might impact banks' liquidity and earnings. To minimize financial stability risks and ensure banks' capacity to provide credit to the economy, the supporting measures should be as targeted as possible and business and households that have not been meaningfully affected by the pandemic should continue to pay their debts.

  - **The declaration of debt moratoria should not come from financial sector supervisors.** The declaration of debt moratoria by supervisors might generate legal risks, adversely affect their reputation and raise questions about their independence and mandate. Other government authorities (e.g., Ministry of Finance, Congress) are usually better positioned to make such a declaration.

  - **Supervisors should thoroughly analyze the nature of the official measures and provide banks with clear guidelines on the prudential implications**. The Basel Committee has clarified that the utilization of a payment deferral should not result in an automatic trigger for "significant increase in credit risk" and, thus, would not necessarily require a migration of loans from stage 1 to stage 2/3 ECL provisioning. Supervisors should communicate their expectations about how measures to support the economy and borrowers should be factored into asset classification, provisioning and other prudential measures.

  - **Supervisors should emphasize that despite the declaration of moratoria, banks should continue to regularly assess the creditworthiness of borrowers**. While the moratorium should not lead to automatic reclassification of assets and increase in provisions, banks' financial statements and reporting should continue to reflect the payment capacity of borrowers. Supervisors should ensure that the procedures used by a bank to measure expected credit losses are robust and timely. Accurate and reliable information is essential for managing risks in the balance sheet over short and long terms and for public authorities to formulate the most appropriate policy responses.

- **Supervisors should continue to closely monitor credit portfolios**. Banks and supervisors should collect information about the scope of the payment moratoria and identify precisely borrowers and exposures subject to these measures (number of borrowers, exposures, split between corporates and households, types of products, etc.).

8. What approach should be considered for countries that have not adopted Basel III standards and may not have capital and liquidity buffers designed to absorb the impact of a crisis?

- **Some EMDEs may not have implemented the Basel III framework yet.** Some of those jurisdictions may have built capital buffers in the form of risk weights or capital requirements above international standards. However, some of the higher capital requirements may have been introduced to address other weaknesses: not all Basel III Pillar 1 risks (including operational risks) may be factored into their minimum capital requirements, credit risk mitigation techniques may be less stringent than those accepted in the Basel framework, they may not be implementing Pillar 2 processes and capital requirements. Also, several jurisdictions have very simple liquidity metrics that do not aim to model a short-term liquidity stress scenario as under the LCR.

- **The general approach outlined in the note still applies for these jurisdictions**. Banks whose capital ratios fall below minimum requirements should submit a credible plan that ensure a gradual restoration of capital over the medium term. Close supervisory follow-up and engagement is needed. Potential measures to restore liquidity levels should be discussed and should be also executed over an appropriate period of time to prevent additional stress on the bank and on the financial system. Enhanced liquidity reporting should be introduced in the meantime.

- **In countries where banks' capital requirements are significantly above international standards, there may be space to make adjustments.** In some countries, the legal and regulatory framework may have embedded buffers into their capital requirements, for example setting minimum ratios of 20 percent or higher. An important distinction is whether those buffers reflect institutional weaknesses—such as low quality of banks' risk management—or whether they are macro-financial in nature—e.g., reflecting systemic vulnerabilities to external shocks. In the latter case, a macroprudential relaxation could be considered. Generally, these countries may have greater flexibility in the design of banks' capital restoration plans which could rely more on tools such as restrictions on dividend distribution and bonus payments when a bank's capital falls below the country's minimum requirements—these tools should in fact be considered in all jurisdictions where bank solvency comes under pressure—but is still within what the authorities can consider a buffer range, i.e., a range that will still support bank soundness. Over the medium term, these jurisdictions could consider the benefit of explicitly designing their capital requirements to incorporate capital buffers that could more readily be used in times of stress. It is important to note that some jurisdictions will have set minimum capital ratios above the international requirements because, even in more stable economic periods, there are local factors that can undermine banks' soundness. Significant caution is needed before relaxing such requirements.

9. What if banks do not have sufficient capital buffers to absorb the losses associated with the crisis?

- **Post-GFC international regulatory standards have strengthened capital requirements and introduced additional capital buffers that could be used during crisis times.** Over recent years, many banks across the world have strengthened their capital positions and are better placed to deal with potential losses in stressed periods.

- **However, if a bank does not have available capital buffers to fully absorb the losses of the crisis without breaching regulatory minima, additional actions are needed to restore the position and thus ensure that confidence is sustained.** Close engagement with the supervisor is key. As described in the note, initiating resolution in such cases during the onset of the pandemic is not advisable—the unprecedented nature of the shock and large uncertainties surrounding the pandemic may justify deferring determinations on bank viability until the impact on the bank's financial position can be estimated more reliably. The authorities should take targeted actions such as asking banks to submit a capital restoration plan to increase capital back to required levels. Given the uncertainty over the long-term impact of COVID-19, such plans may need to be more speculative and have a longer time horizon than usually would be the case (outside of public support).This plan should be discussed with the supervisor who needs to assess the plan, discuss with the bank any needed changes, and monitor its implementation to ensure that the bank will be able to return to a normal situation in a reasonable time.

- **In case the capital restoration plan is not being complied with, the supervisor should discuss on a pro-active basis any potential or existing difficulties to meet the targets in the capital plan**. The supervisor should also assess the underlying reasons, and whether any modifications to the plans or additional supervisory corrective actions may be needed. Where banks are unable to submit a credible capital restoration plan and where the confidence in the banking system would be severely impaired and resolution cannot be effectively implemented, authorities may need to provide public support, particularly in jurisdictions that have the fiscal capacity to credibly provide such support.
- **There could be cases where some banks may have already weak capital and financial position and already under corrective measures by the supervisors.** It should be clear that for those weak banks, the supervisor should continue to take action to remedy their weaknesses and that the targeted supervisory response discussed above is limited to problems linked specifically to the temporary impact of the crisis. These banks may have significant difficulty to absorb the losses and to restore their capital position as per the plan. In these cases, the supervisor should assess, as it usually does on ongoing basis, the weaknesses and problems of the bank, and of the financial system, and whether escalated corrective measures are needed. Banks that were failing before the pandemic should still be resolved, if it can be done effectively (e.g., in countries that are yet to experience the worst of the pandemic). This will depend in part on the size of the bank, its complexity, and the operational readiness of the resolution authorities. If operational challenges are too high and banks whose failure would be systemic cannot be resolved immediately, authorities should be careful that managers cannot in the interim "gamble for resurrection" (e.g., to rapidly extend credit to risky borrowers) or commit fraud and "asset stripping" (e.g., to lend to connected parties that will not repay). Supervisors should apply intense supervisory oversight and use their corrective and sanctioning powers as appropriate to minimize these risks, subject to the operational constraints they face.

10. How to deal with countries where banking systems do not have capital buffers to absorb the impact of the crisis and there is limited fiscal space to provide additional government support?

- **The lack of capital buffers in the banking systems of those countries may be indicative of their fragilities before the outbreak.** Hence the starting position for these banks is already weak and may have been further exacerbated by the crisis.
- **The approach to be followed in these countries should be assessed on a case-by-case basis.** Many banks may fall below capital requirements due to the losses associated with the crisis. Supervisors should assess the situation of each bank. Some banks may be able to ensure gradual restoration of capital over the medium term under a close follow-up and engagement by the supervisor. For the other banks which may have a more difficult situation and may be exhibiting signs that they are unviable, more drastic measures, such as fiscal support (with appropriate protection of taxpayers' interests) should only be considered where the confidence in the banking system would be severely impaired and resolution cannot be effectively implemented.
- **As outlined in the note, there is no supervisory or accounting trick that will make losses disappear.** Credit losses will eventually need to be borne by banks and their shareholders/creditors, or by the government, if necessary, to preserve financial stability. While supervisory flexibility could be sought in particular cases, it should be targeted to problems associated with the crisis and ensure that it does not put the health and viability of the banking system at risk.

11. How supervisors should address the implications of higher market volatility and the sharp fall of asset prices created by the pandemic?

- **Fair value measurement and classification and reclassification of financial assets are governed by accounting rules.** The channels through which the impact will affect banks depend on the accounting framework adopted in each country. Under International Financial Reporting Standards (IFRS) 9, financial assets should be classified at fair value through profit and loss (FVTPL), unless they meet the criteria to be classified at either Amortized Cost or Fair Value Through Other Comprehensive Income (FVOCI), based on their business model for managing the financial asset and the contractual cash flow characteristics of the financial asset. For FVTPL assets, changes in fair value are recognized in profit and loss as they arise. Reclassification of financial assets under IFRS 9 follows more strict criteria than under IAS 39. Reclassification is allowed if and only if the reporting entity's business model objective for its financial assets' changes and its previous model assessment would no longer apply. Business model change requires management decision and is expected to be very infrequent and uncommon.[2]
- **Supervisors should ensure that banks observe the accounting criteria for potential reclassifications**. Supervisors need to enforce adherence to these criteria. If reclassification is deemed to be appropriate based on IFRS 9, it must be done prospectively from the reclassification date which is the first day of the first reporting period following the change in business model.
- **It is important to maintain the confidence in the banking sector by ensuring that marked-to-market losses are not hidden.** "Marked-to-market relief" (allowing banks to maintain the price of specific securities

[2] Among others, here are two examples from IFRS 9 which do not constitute a change of business model: (i) a change in intention related to particular financial assets (even in circumstances of significant changes in market conditions); and (ii) a temporary disappearance of a particular market for financial assets.

fixed) undermines transparency and market discipline and is incompatible with international accounting and prudential standards. Changes to the capital framework aiming to filter potential negative impact on regulatory capital from securities classified at FVOCI also weakens the regulatory framework and hinder international comparison. When market illiquidity prevents the use of market prices, supervisors should carefully monitor banks' approach for asset valuation and the governance of the valuation process to ensure compliance with best practices and international standards.

12. When banks are applying the internal model approach to market risk, should supervisors introduce measures to mitigate the volatility-induced pro-cyclicality of capital requirements?

- **There is no need to change the prudential requirements. Instead, the flexibility embedded in the standards should be used prudently.** As expected and intended, risk-sensitive capital requirements based on internal Value-at-Risk (VaR) models and stressed VaR models have increased as a result of extreme market volatility. This is justified as more capital is needed to cover higher market risks. It is also essential to ensure that the performance of internal models remains satisfactory in the current environment. To assess how well internal models capture risk factors that also drive the daily results, regulators impose a back-testing requirement (i.e., an ex post comparison between VaR measure and daily profit and losses outcomes). When the number of exceptions is high (i.e., the loss incurred on a single day is greater than the loss indicated by the model), a penalty is usually applied. In the recent period, several regulators have introduced exemptions concerning the number of back-testing exceptions that are taken into consideration to determine whether a multiplier (the 'plus factor' in the Basel framework) needs to be applied when calculating capital requirements for market risks.
- **While recognizing that some exceptions may be explained by an increase in volatility, banks and supervisors should continue to analyze carefully and thoroughly the results of the back-testing.** The BCBS guidelines on back-testing provide regulators with the necessary flexibility. In that respect, it is important to make a distinction between several types of problems (serious shortcomings of the model, lack of model precision, or markets moved in a fashion unanticipated by the model), which may require a different supervisory response (recalibration of models, use of multipliers, enhanced monitoring, etc.). Depending on the issue at stake, the use of the 'plus factor' is not always relevant, but in-depth investigations should be conducted to understand the reasons behind a large number of back-testing exceptions. In any case, supervisors should challenge banks, have adequate monitoring requirements in place, ensure that banks continue to measure the performance of VaR models (the back-testing being one of the tools), request detailed information about exceptions, and require models' adjustments where necessary.

13. Should applying IFRS 9 ECL requirements take into account the current development related to COVID-19?

- **It will be important for reporting entities to exercise sound judgement in meeting IFRS 9 ECL requirements and accompanying disclosure standards, to ensure timely and sufficient recognition of credit losses.** This entails taking into account new information related to COVID-19 developments in performing economic forecasts and assessing whether there is a significant increase of credit risk and lifetime ECL (see box below for ECL assessment of restructured loans). Proper and sufficient disclosures will be especially important in achieving transparency and informing the investors and the market of the economic condition and financial performance of the banks, including the impact of COVID-19 on credit risk. This information will also be an important input for regulators in forming their policy response. Banking supervisors are expected to play an important part in helping banks to implement IFRS 9 and evaluating banks' IFRS 9 practices. To this end, supervisors are encouraged to continue to follow the Basel Committee's "Guidance on Credit Risk and Accounting for Expected Credit Losses", which can serve as a useful guidance for banks as well.

- **It is fine for supervisors to provide guidance to banks on how to think about the impact on their loan portfolios over the life of the loans to support robust and consistent implementation of IFRS 9.** Banks would need to exercise sound judgement in applying IFRS 9 especially at this time when there is a significant amount of uncertainty. In the current environment, ECL assessment should take into account the temporary nature of the virus impact, best available information, and relevant fiscal support measures and use a range of scenarios to support credit risk analysis, including the downside scenario in the current situation. At the same time, banks and supervisors should bear in mind that IFRS 9 is principle-based and therefore should not be applied mechanically and avoid blanket treatment and automatic triggers. For example, payment holidays should not automatically result in banks moving to stage 2 as this does not necessarily imply that there has been a significant increase of credit risk. In building scenarios, it may also be useful to bear in mind that if the situation becomes prolonged, at some point, COVID-19 may have an impact on the longer-term scenarios. (On March 27, the IFRS Foundation issued guiding principles on how to apply IFRS 9 ECL requirements in light of the COVID-19 pandemic. This information is publicly available on www.ifrs.org.)

IFRS-9: ECL Assessment for Restructured Loans

The accounting treatment of restructured loans depends on whether the modification of loan terms is substantial.[1] If the modification is substantial, the original asset is derecognized, and the modified asset is considered a "new" one and recognized at a lower amount. Entities should then measure 12-month ECL at initial recognition until the requirements for the recognition of lifetime ECL. If the modification is not considered substantial, the entity should first recalculate the gross carrying amount of the asset and recognize a modification gain or loss in P&L. If there is a significant increase of credit risk, lifetime ECL would need to be recognized. To move from lifetime ECL to 12-month ECL, an entity needs to consider whether the borrower has demonstrated consistently good payment behavior over a period of time based on the modified terms before the credit risk is considered to have decreased. The amount of provisions might not be substantial if the terms of the loans are extended and/or the borrowers are able to meet their obligations under the modified loan contract.

[1] The modification of a financial asset is considered substantial if the present value of the cash flows under the new terms, including any net fees paid, discounted using the original effective interest rate, is at least 10 percent different from the discounted present value of the remaining cash flows of the original asset.

ANNEX 2. Comparison Between the Prudential, Accounting, and Reporting Framework

Prudential framework **-> impact on the denominator of the capital adequacy ratio (risk-weighted assets)**	**Accounting framework (IFRS 9)** **-> impact on the numerator of the capital adequacy ratio (regulatory CET1 capital is generally reduced by any reduction in retained earnings due to credit allowances)**	**Regulatory reporting framework** **-> impact on regulatory classification (performing vs. nonperforming) used for reporting purpose**
Definition: A **default** is considered to have occurred with regard to a particular obligor when either or both of the two following events have taken place: (1)The bank considers that the obligor is unlikely to pay its credit obligations; (2) The obligor is past due more than 90 days on any material credit obligation to the bank. NB: a distressed restructuring of the loan where this is likely to result in a diminished financial obligation caused by the material forgiveness, or postponement, of principal, interest is an indication of unlikeliness to pay. *Source: Basel framework*	Definition: **Stage 1**: credit risk has not significantly increased since origination (12-month ECL). **Stage 2**: credit risk has significantly increased since origination (lifetime ECL). A financial asset is credit-impaired (**Stage 3**) when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include observable data about the following events: … (a) significant financial difficulty of the borrower; (c) the lender of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession that the lender would not otherwise consider (lifetime ECL) (IFRS 9, Appendix A).	Definition: **Forbearance** occurs when (i) a borrower is experiencing financial difficulty in meeting its financial commitments and (ii) a bank grants a concession that it would not otherwise consider. **Nonperforming exposures** are: (1) all exposures that are "defaulted" under the Basel framework; (2) all exposures that are credit-impaired according to the applicable accounting framework; (3) all other exposures that are not defaulted or impaired but nevertheless: (a) are material exposures that are more than 90 days past due (b) where there is evidence that full repayment based on the contractual terms, original or, when applicable, modified is unlikely without the bank's realization of collateral. *Source: BCBS Guidelines - Prudential treatment of problem assets*

Prudential implications	Accounting implications	Reporting implications
A risk-weight (RW) of 75 percent is assigned to the exposure.	Loan is classified in Stage 1, thus requiring a loss allowance at an amount equal to 12-month ECL.	Exposure is performing.
A RW of 75 percent continues to be assigned to the exposure.	Loan remains classified in Stage 1, thus requiring a loss allowance at an amount equal to 12-month ECL.	Exposure is still performing.
A RW of 75 percent continues to be assigned to the exposure.	**Loan moves to Stage 2** (underperforming) requiring lifetime ECL [There is a rebuttable presumption that credit risk has significantly increased if contractual payments are more than 30 days past due].	Exposure is still performing.
A RW of 100 percent is assigned to the exposure. The borrower is not classified as defaulted since the impact of the loan restructuing on the net present value (NPV) of the cash flows of the loan is expected to be small.	Loan remains in Stage 2, requiring lifetime ECL, as there is no detrimental impact on the estimated cash flows of the loan.	A **forbearance measure** is identified, as a concession has been granted due to the borrower's financial difficulties. The loan which is subject to individual measures targeted to the borrower's situation will be reported as a forborne loan. [However, when borrowers accept the terms of a general payment moratorium (public or granted by banks on a voluntary basis), **this should not automatically lead to the loan being categorized as forborne**, as specified by the BCBS]. The exposure is still considered as performing as (i) the borrower has not defaulted under the Basel standards, (ii) the exposure is not credit impaired under the accounting rules, and (iii) payments are not more than 90 days past due. Exposure will be reported as **Performing forborne** for two years.
The distressed restructuring of the loan results in a diminished financial obligation (reduced NPV). **The borrower is therefore reclassified as defaulted.** The defaulted exposure is risk-weighted at 150 percent.	**The loan is credit impaired**. The concession has a detrimental impact on the estimated cash flows of the loan. If the modification of the terms of the transaction is substantial, the modified loan is considered a “new” one and 12 month ECL is measured at initial recognition until the requirements for lifetime ECL measurement are met. [There is also a 90 day rebuttable presumption for stage 3: default does not occur later than when a financial asset is 90 days past due unless an entity has reasonable and supportable information to demonstrate that a more lagging default criterion is more appropriate].	The exposure is **nonperforming** as the borrower has defaulted and the loan is credit impaired. The loan will be classified and monitored as nonperforming for one year.
The borrower is classfied as defaulted, as there are several indications of unlikeliness to pay (income is reduced by 70 percent). To reflect the presence of a guarantee, the ubstitution approach is applied: the RW assigned to the borrower (150 percent) is replaced with a RW assigned to the guarantor (0 percent).	**The loan is credit impaired** (significant financial difficulty of the borrower). The determination of the recoverable amount of the loan will take into consideration that the cash flows of the loan are guaranted by the state.	The exposure is **nonperforming** as the borrower has defaulted and the loan is credit impaired. The loan will be classified and monitored as nonperforming for one year. Collateralization or received guarantees have no direct influence on the categorization of an exposure as nonperforming.

ANNEX 3. Clarification Provided by the BCBS

Prudential framework **-> impact on the denominator of the capital adequacy ratio (risk-weighted assets)**	**Accounting framework (IFRS 9)** **-> impact on the numerator of the capital adequacy ratio (regulatory CET1 capital is generally reduced by any reduction in retained earnings due to credit allowances)**	**Regulatory reporting framewok** **-> impact on regulatory classification (performing vs. nonperforming) used for reporting purpose**
<u>Definition</u>: A **default** is considered to have occurred with regard to a particular obligor when either or both of the two following events have taken place: (1) The obligor is past due more than 90 days on any material credit obligation to the bank; (2) The bank considers that the obligor is unlikely to pay its credit obligations. NB: a distressed restructuring of the loan where this is likely to result in a diminished financial obligation caused by the material forgiveness, or postponement, of principal, interest is an indication of unlikeliness to pay. *Source: Basel framework*	<u>Definition</u>: **Stage 1**: credit risk has not significantly increased since origination - SICR (12-month ECL). **Stage 2**: credit risk has significantly increased since origination (lifetime ECL). A financial asset is credit-impaired (**Stage 3**) when <u>one or more events</u> that have <u>a detrimental impact</u> on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include observable data about the following events: … (a) significant financial difficulty of the borrower; (c) the lender of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession that the lender would not otherwise consider (lifetime ECL) (IFRS 9, Appendix A).	<u>Definition</u>: **Forbearance** occurs when (i) a borrower is experiencing financial difficulty in meeting its financial commitments and (ii) a bank grants a concession that it would not otherwise consider. **Nonperforming exposures** are: (1) all exposures that are "defaulted" under the Basel framework; (2) all exposures that are credit-impaired according to the applicable accounting framework; (3) all other exposures that are not defaulted or impaired but nevertheless: (a) are material exposures that are more than 90 days past due (b) where there is evidence that full repayment based on the contractual terms, original or, when applicable, modified is unlikely without the bank's realization of collateral *Source: BCBS Guidelines - Prudential treatment of problem assets*

Prudential implications	Accounting implications	Reporting implications
Capital treatment of loans subject to payment moratoriums initiated in response to the COVID-19 outbreak: - payment moratorium periods (public or granted by banks on a voluntary basis) relating to the COVID-19 outbreak **can be excluded** by banks from the counting of days past due. - the assessment of unlikeliness to pay should be based on whether the borrower is unlikely be able to repay the **rescheduled payments.** Loans subject to government guarantees: - When determining a bank's credit risk requirement for loans that are subject to sovereign guarantees, the relevant sovereign risk weight should be used.	Significant increase in credit risk (SCIR): - relief measures to respond to the adverse economic impact of COVID-19 such as public guarantees or payment moratoriums, granted either by public authorities, or by banks on a voluntary basis, **should not automatically result** in exposures moving from a 12-month ECL to a lifetime ECL measurement. Measurement of ECL: - Where banks are able to develop forecasts based on reasonable and supportable information, the Committee expects ECL estimates to **reflect the mitigating effect** of the significant economic support and payment relief measures put in place by public authorities and the banking sector. While estimating ECL, banks should not apply the standard mechanistically and should use the flexibility inherent in IFRS 9, for example to give due **weight to long-term economic trends**.	Exposures subject to forbearance measures such as moratorium: When borrowers accept the terms of a payment moratorium (public or granted by banks on a voluntary basis) or have access to other relief measures such as public guarantees, this should **not automatically** lead to the loan being categorized as forborne. Definition of NPE in relation to loans subject to moratorium: The BCBS' guidance on the definition of NPE assets uses the 90 days past due and the unlikely to pay criteria. Payment moratorium periods (public or granted by banks on a voluntary basis) relating to the COVID-19 outbreak **can be excluded** by banks from the number of days past due; assessment of unlikeliness to pay should be based on whether the borrower is unlikely be able to repay the **rescheduled payments** (i.e., similar to the capital framework).