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Briefing note on the use of the flexibility envisaged in the accounting standards in view of the shock caused by COVID-19

The Banco de España reminds financial institutions of the importance of defining and applying their accounting policies in a responsible manner in view of temporary and exceptional containment measures

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The public health emergency created by the spread of COVID-19, and the necessary containment measures adopted, are having a very severe impact on the Spanish economy, affecting firms and households. To complement the extraordinary emergency measures to address the economic and social impact of COVID-19, set out in Royal Decree Law 8/2020 of 17 March 2020, it is essential that financial institutions (credit institutions, specialised lending institutions, electronic money institutions and payment institutions) continue to provide financial support to firms and households that have been adversely affected by this temporary and exceptional situation.

To support financial institutions in their important role of funding the real economy, and thus facilitate its subsequent recovery once the public health emergency has been overcome, European banking regulatory and supervisory authorities are recommending that full use be made of the flexibility embedded in the regulatory framework.

In particular, the European Central Bank (ECB) has announced a set of measures designed to give the credit institutions under its direct supervision more flexibility. Credit institutions will be able to make use of their capital and liquidity buffers, and a more flexible approach has been introduced as regards supervisory deadlines and processes, aimed at reducing the operational burden.

The Banco de España, as a national competent authority under the Single Supervisory Mechanism (SSM), adopts the measures notified by the ECB and extends them, insofar as applicable, to all the financial institutions over which it exercises direct supervisory powers.

Specifically, in its press release of 20 March 2020,[1] relating to credit risk, the ECB gives credit institutions further flexibility:

- In the case of loans under public support measures, affecting among other aspects their classification as non-performing (debtors unlikely to pay) when banks call on public

[1] Press release of 20 March 2020: ECB Banking Supervision provides further flexibility to banks in reaction to coronavirus.

guarantees, or loans under COVID-19 related public moratoria granted in the context of the ongoing public health emergency.

- In addition, loans that are under public guarantees and that become non-performing will benefit from preferential prudential treatment in terms of supervisory expectations about loss provisioning.

- The way in which banks implement their non-performing loan (NPL) reduction strategies will be analysed with full flexibility, taking into account the current market conditions.

- Lastly, bearing in mind the high level of uncertainty about the impact of the public health emergency, the ECB recommends that banks place more focus in their expected loss forecasts on more stable, long-term scenarios based on historical performance.

Furthermore, on 25 March, the European Banking Authority (EBA)[2] and the European Securities and Markets Authority (ESMA)[3] each published a statement clarifying their expectations regarding the application of the prudential and accounting frameworks in the context of the health crisis and the measures adopted to mitigate it. These statements included, inter alia, the following:

- The EBA notes that the offering and acceptance of terms set out in general moratoria would not necessarily lead to a reclassification of any loan under the definition of forbearance.

- ESMA recalls that the presumption that exposures with amounts past due more than 30 days should be reclassified in Stage 2 (exposures with significant increase in credit risk since initial recognition) is rebuttable.

- ESMA states that significant increases in credit risk, which lead to classification in Stage 2, are identified by considering the entire expected life of the transaction. Therefore, the institution must analyse the extent to which sudden changes in the short term, give rise to impacts over the entire life of the transaction. It also emphasises that moratoria and other measures that allow payment to be postponed that are granted as a result of the situation generated by COVID-19 need not automatically lead to the identification of a significant increase in credit risk.

In this context, the Banco de España reminds financial institutions of the importance of defining and applying their accounting policies reasonably, taking into account the temporary and exceptional nature of the measures to contain COVID-19. It is therefore appropriate to make use of the flexibility provided for in the accounting standards, without prejudicing the appropriate identification of credit impairment or the reasonable estimation of credit risk coverage.

[2] Statement of 25 March 2020 on the application of the prudential framework in light of COVID-19 measures.
[3] Public statement of 25 March 2020 (ESMA32-63-951): Accounting implications of the COVID-19 outbreak on the calculation of expected credit losses in accordance with IFRS 9.

Use of the flexibility existing in the accounting framework involves, inter alia, avoiding the automatic use of indicators and hypotheses that, although reasonable in normal circumstances, may not be in exceptional circumstances not envisaged in that framework.

In this respect, in relation to the classification and credit risk coverage, it should be noted that:

- The existence of amounts past due **more than 30 days** is a **rebuttable presumption** for classification in Stage 2 (exposures with significant increase in credit risk since initial recognition). Therefore, exposures with amounts past due more than 30 days will not **automatically** be classified in Stage 2 if there has not been a significant increase in their credit risk.

- To determine if there has been a **significant increase in the credit risk** of exposures requiring their classification to Stage 2, the entire life of the transaction must be taken into account. That is to say, it is necessary to assess whether the possible changes in payment behaviour that are considered isolated or temporary have a significant impact on credit risk over the **entire life of the transaction.**

- Only those modifications of transactions where the counterpart is experiencing or likely to experience financial difficulties should be identified as **forborne**; otherwise they would be **rollovers or renegotiations.** The existence of liquidity difficulties in the case of borrowers with a **good payment history** would not automatically lead to identification of forbearance in the event of modifications of transactions **as a result of the COVID-19 crisis at the time they are granted**. Such transactions may **continue to be classified in performing** insofar as there is no reasonable doubt regarding their repayment and there has been no significant increase in credit risk (see previous point).

- The incorporation of the effect of **forecasts of future economic conditions** in the estimation of credit risk coverage should be based on **reasonable and supportable** information. Thus, this incorporation should give more weight to forecasts that do not have a high degree of uncertainty, which may reduce the **reliability** of the estimates. Until reliable information is available on the impact of COVID-19, institutions should, depending on the maturity of the transaction, give more weight to long-term projections.

Without prejudice to the above, the Banco de España expects financial institutions to incorporate into their accounting and risk management systems, for all transactions that are directly affected by the above considerations in relation to COVID-19, the relevant identifiers, which they will have to report to the Central Credit Registry (CIRBE), in accordance with the specifications that will be notified to them. Also, they are reminded that they must subject such transactions to appropriate monitoring and internal control.