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Key regulatory considerations for German and other Eurozone banks in relation to COVID-19

In response to the potentially drastic economic effects of COVID-19, the European Central Bank (ECB), the European Banking Authority (EBA) and national competent authorities, including the German Federal Financial Supervisory Authority (BaFin), issued statements on 12 March 2020 with a view to mitigate the impact on banks, following an earlier communication of the Chair of the ECB Supervisory Board on 3 March 2020.

The aim of the regulatory guidance is twofold. It primarily serves as a reminder to banks of their obligations, in particular with regard to contingency planning. On the other hand, it is equally intended to provide a certain relief to banks in order to facilitate their continued ability to fund households and the real economy. Building on the guidance, this briefing outlines some key regulatory considerations that are relevant for banks in the current environment.

Separately, the ECB announced certain monetary policy measures which include an expansion of its existing commitment on bond purchases and the launch of a new programme that offers loans to banks at favourable conditions to encourage lending to small businesses. In Germany, the government introduced a package of economic and fiscal measures to ensure sufficient liquidity is available to businesses comprising, inter alia, KfW (the state development bank) funded liquidity assistance programmes.

Obligations of banks – Minimising potential adverse effects of COVID-19

Contingency planning

In line with their general obligation to adopt effective risk management processes, the ECB reminds banks to consider and address pandemic risk in their contingency strategies to ensure business continuity and thereby minimise potential adverse effects of COVID-19. In the context of a pandemic threat, contingency planning requires banks to identify and assess potential scenarios at different stages of an outbreak and measures to sustain, in particular, critical operations.

Focus areas of the guidance of the ECB concern personnel and measures to reduce infection transmission and the resilience of the IT infrastructure in view of potential higher reliance on remote access and remote services and possible increase in cyber security risk. Banks have already adopted protective measures, including working from home arrangements for staff. In case banks have to reallocate staff, the requirement to separate front- and back-office functions continues to apply.

Further, banks should assess how business continuity is maintained in respect of outsourced functions. This may require an exchange with material outsourcing providers on their exposure to the pandemic risk and corresponding contingency measures.

In case a bank subject to the direct supervision of the ECB identifies significant shortfalls when testing contingency measures or experiences any other significant developments, the ECB expects the bank to immediately inform their JST. In the letter of the Chair of the ECB Supervisory Board on 3 March 2020, banks were also requested to inform their JST Coordinator about the contact details of the team and key person responsible for business continuity.

Recovery plans and recovery measures

In the event of a deterioration of their financial situation, various escalation procedures under the existing recovery plans of banks may be triggered. Banks should be prepared to promptly implement recovery actions and assess the availability of potential recovery options. Adverse effects may also include contagion effects in case other institutional counterparties experience difficulties or even become subject to early intervention or resolution measures, including a temporary suspension of payment or delivery obligations.

In a statement on 13 March 2020, the European Commission emphasised the key role of the banking sector in dealing with the effect of the COVID-19 outbreak, by maintaining the flow of bank credit. While the European Commission did not have any evidence that banks are currently experiencing any liquidity constraints, it acknowledged that the European Union framework allows Member States to provide, where appropriate, support to banks in the form of state guarantees and clarified that state aid granted to compensate for direct damage suffered as a result of the outbreak would not be qualify as extraordinary public financial support. Accordingly, aid fulfilling these requirements will not result in a failing or likely to fail assessment under the SRM Regulation or the BRRD and thus the triggering of banking resolution.

Maintaining a sound capital base and robust risk management

Banks are cautioned to adopt dividend policies using conservative and prudent assumptions as part of an adequate risk management. In this regard banks should consider to what extent their decision-making on the annual financial statements and dividend distribution anticipates potential deteriorated economic and financial conditions in light of the COVID-19 outbreak. With regard to the implications of COVID-19 on the ability of German companies to hold their annual general meeting, we refer to our client briefing of 9 March 2020. Similarly, banks are required to apply a forward-looking stance when determining the bonus pool for variable remuneration with a view to maintain a sound capital base.

While the statements of the ECB and the European Commission underline the tension between the aim to ensure the financial stability of the banks and their key role in dealing with the economic effects of COVID-19 by financing households and corporates experiencing temporary difficulties, banks must continue to apply a robust risk management also when extending new credit. The relief granted by supervisors serves to enable banks to use their existing capital and liquidity buffers to maintain their capacity to lend during economic downturn, but there is no indication yet that it shall relax the standards which banks must apply when lending. However, where borrowers may no longer fulfil the necessary credit requirements, it may be possible to use newly introduced or extended guarantee programmes by governments or public promotional banks that have been announced in order to deal with the crisis (in Germany, e.g. by KfW).

Relief by supervisors – Measures facilitating banks to overcome the impact of COVID-19

Prioritisation of operational continuity

The EBA, the ECB and national competent authorities like BaFin recognise that various measures forming part of their ongoing prudential supervision pose an operational burden for supervised banks. In the interest of prioritising the banks' continued ability to perform their core operations, the EBA and the ECB postponed their stress tests scheduled for 2020. In addition, the ECB signalled vis-à-vis the banks under its direct super¬vision to extend deadlines for the implementation of previously requested remedial actions and for non-critical supervisory measures and data requests. This may also include a rescheduling of on-site inspections. BaFin communicated to adopt the same approach in respect of the less significant banks under its direct supervision.

Capital and liquidity

As regards the bank-specific Pillar 2 Requirement (P2R), the ECB will allow banks to meet the required capital ratio by partially using capital instruments other than instruments qualifying as Common Equity Tier 1 (CET1), i.e. Additional Tier 1 and Tier 2 instruments. This treatment anticipates the rules which will apply under the revised Capital Requirements Directive (CRD V) coming into effect in 2021. On the basis of the communication of the ECB, it is not entirely clear whether the ECB will individually specify the guidance on the composition of capital to meet the P2R by amending the currently applicable supervisory decisions adopted as part of the annual Supervisory Review and Evaluation Process (SREP). The announcement of the ECB does not indicate whether banks could expect that the capital ratio required under the bank-specific P2R will be otherwise relaxed.

In the first quarter of 2020, BaFin as national macroprudential authority raised the domestic countercyclical capital buffer (CCyB) from 0 to 0.25% for the first time, applicable as of 1 July 2020. At this point in time, it is unclear whether BaFin will again reduce the CCyB to 0. The CCyB set by BaFin is relevant with respect to risk exposures in Germany, whereas risk exposures of German banks in other EEA states or third countries are linked to the respective CCyB set by the national macroprudential authority in the relevant jurisdiction.

In the event that capital falls below the applicable combined buffer requirement, banks will be restricted to make distributions in the form of dividends on CET 1 instruments, variable remuneration and payment to holders of Additional Tier 1 instruments by the limits of the maximum distributable amount (MDA). In this regard, the guidance issued by the ECB and BaFin does not provide for any form of waiver. This is, however, in line with the policy goal to enable banks to support the economy, but not to use the capital relief to increase dividend distributions or variable remuneration.

The level of banks' capital ratios is likely to decrease due to a material deterioration of the financial situation of their obligors, i.e. existing borrowers and counterparties, as a consequence of the effects of COVID-19. As a general rule, banks are required to take the default of an obligor in account when determining their risk-weighted assets and

to timely reflect any deterioration in asset quality (cf. Art. 127, Art. 178 CRR). A default is considered to have occurred where the obligor is either unlikely to pay its credit obligations or past due more than 90 days on any material obligation. While for banks the solely quantitative "past-due" criterion is rather inflexible, the "unlikely-to-pay" criterion may leave a certain room for banks when assessing the repayment capacity of their customers in the current environment. In particular, the fact that public support programmes have been initiated for a wide range of businesses affected by COVID-19 may be taken into account where customers with a deteriorated financial standing can potentially access special economic or fiscal programmes.

The EBA emphasises that its Guidelines on management of non-performing and forborne exposures leave flexibility in their implementation and calls on supervisors and banks to engage in a close dialogue on a case-by-case basis in the context of the current developments.

Delay of public disclosure?

Should banks themselves experience difficulties in case the crisis worsens significantly, the occurrence of certain events concerning an affected bank may constitute inside information where that bank is subject to the regime of the Market Abuse Regulation (MAR). As a general, the bank would be required to disclose such information. However, in case the disclosure entails a risk of undermining the financial stability of the bank and the financial system, the bank concerned may delay public disclosure provided this is in the public interest, confidentiality of that information can be ensured and the competent market authority has consented to the delay (cf. Art. 17 (5) MAR). This rule may be particularly relevant in the event that a bank experiences a temporary liquidity problem and needs to receive temporary liquidity assistance.

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