JVI Webinar

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Borrower Relief Measures in the Europe and Central Asia Region

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Agenda

1. **Introduction**
2. ECA region post-GFC and pre-COVID-19
3. COVID-19-related borrower relief measures
4. A few preliminary guiding principles

Overview: the COVID-19 pandemic impact

1

The **outbreak of the COVID-19** pandemic in the first quarter of 2020 has prompted a series of **unprecedented emergency measures**:

- Travel bans, mandatory closure of non-essential business, limitations on gatherings, mandatory home-based work, border closures et cetera.

2

Policymakers around the globe have **spurred into action**:

- **Fiscal support** measures to affected sectors.
- **Monetary and liquidity measures** aimed at stabilizing stressed global funding markets.

3

Within a few weeks, **many borrowers have seen their income flow drastically reduced or dried up** altogether due to COVID-19.

4

Borrowers ranging from large corporates to households are already or will soon experience **serious difficulties in staying current on their debt obligations**.

Overview: the financial response in ECA region

1 In order to preserve economic activity, livelihoods, and jobs, many countries have quickly introduced **measures designed to provide relief to distressed borrowers**.

2 Common denominator is that they introduce **temporary concessions to the contractual terms of borrowers' repayment obligations** on loans owed to banks.

3 In this way, and in marked contrast to the global financial crisis (GFC), **banks are expected to be able to provide a positive contribution to the mitigation of the economic fallout from COVID-19**.

4 At the same time, if taken too far, **these measures could lead to stability challenges** further down the road, with a weakening banking sector exacerbating the adverse **economic impact of COVID-19**.

Introduction to the WB policy note

- Policymakers in **ECA region** have been quite active in **rolling out borrower relief measures**.
- **We have prepared a policy note** reviewing early experiences, **highlighting some of the basic choices that policymakers face in designing borrower relief measures**, and identifying a preliminary and concise set of **high-level principles**
- Decisions to implement **short-term borrower support measures were often taken in very short order**, and possibly **without fully considering all the ramifications**.
- Point of departure for the policy note is that , under the current extraordinary circumstances, **temporary borrower relief measures might be needed to preserve economic activity**…
- …but that **their design needs to be carefully thought through to protect the longstanding public interest in safe and sound banking systems**, and financial stability.
- This message has a special resonance for **ECA region which includes many that were hit hard by the GFC**.
- Policy note is publicly available on the **FinSAC website** (link).

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ECA region post-GFC and pre-COVID-19

The 2008 Global Financial Crisis

Pre-GFC

- Plentiful and cheap **financing from eurozone-based parent banks**
- **Booming asset and real estate prices** and steep increases in household and corporate debt

2008 GFC

GFC

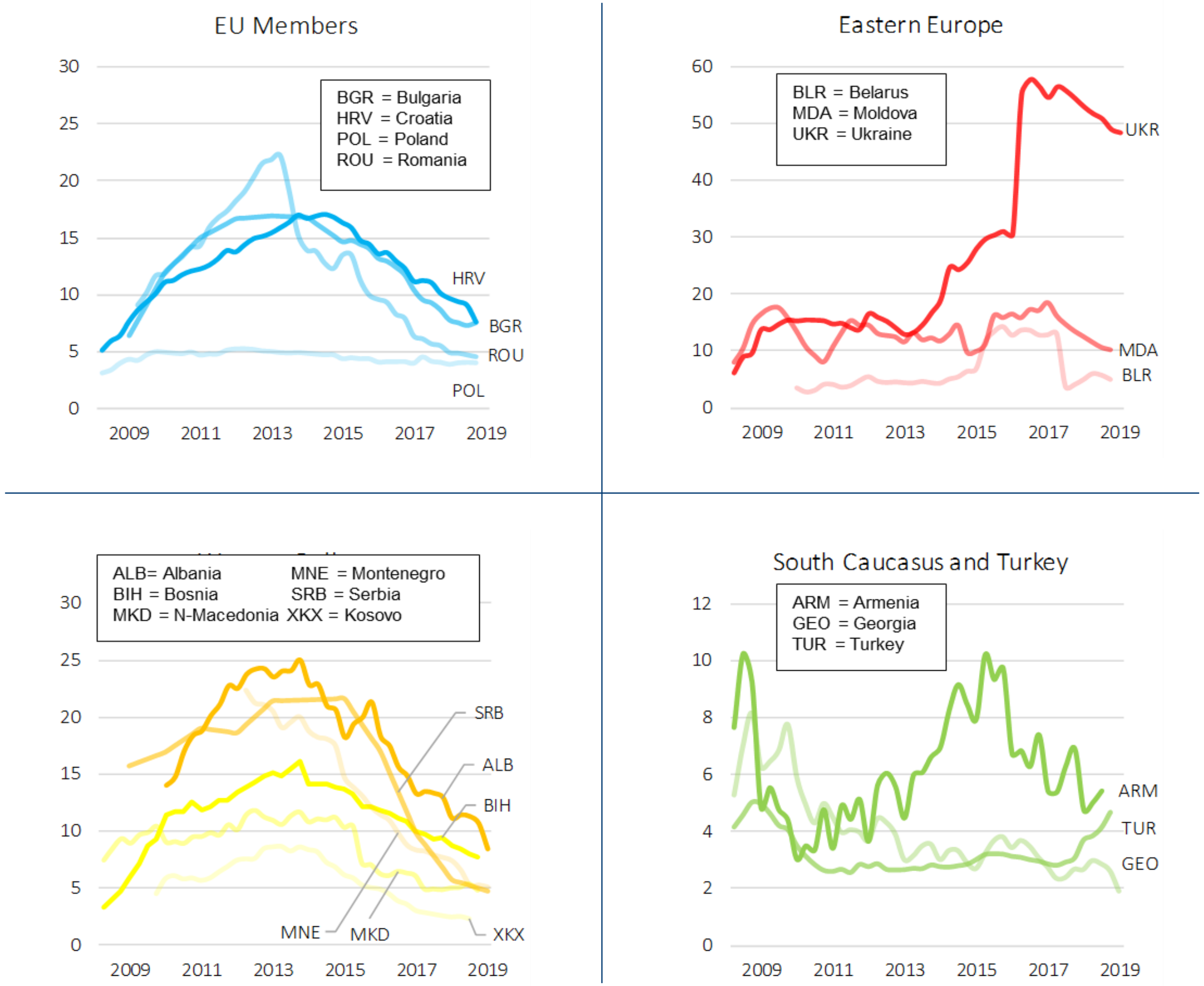
- **Inflows from parent banks dried up in 2008** and local subsidiaries experienced a funding shock
- **Steep decline in credit growth, asset and real estate booms went bust**, and sharp economic slowdown
- **Steady increases in NPL ratios across the region**

Post-GFC:

- The Global Financial Crisis left an **enduring legacy of high NPLs in local bank-dominated financial sectors**.
- The high stock of NPLs made it **difficult for banks to effectively fulfill their intermediation function in the bank-dominated financial sectors in the region**, (i) **compromising their capacity to finance** new and dynamic sectors, (ii) **reducing the availability of fresh credit**, (iii) **driving up the cost of finance**, and (iv) **weakening economic growth**.
- Many ECA countries embarked on **EU-inspired reforms**, including **aligning regulatory definitions of NPLs and forborne exposures**.
- ECA countries **also embarked on much-needed legal, institutional, and taxation reforms** to strengthen insolvency frameworks, establish out-of-court mechanisms, and promote the write-off of fully provisioned NPLs.

Current economic environment

- **Implemented measures**, together with an **improving economic outlook in the EU and an acceleration in credit growth**, helped to set the stage for a gradual improvement, with NPL ratios receding from their post-GFC peaks.



Despite the encouraging trends of the past years:

- There are **some concerns about the sustainability of the improvement in banks' reported asset quality indicators**, as the decrease in NPLs has not been matched by a similar strengthening of the financial position of banks' borrowers.

- WBG's corporate health studies in ECA region in 2018 and 2019, highlighted that:

  - **Large corporates** (accounting for the bulk of the outstanding credit stock) continued to suffer from **high levels of indebtedness** and **weak financial condition**.

  - **Relatively few liquidations of distressed corporates**, with financially weak companies often kept afloat thanks to a **combination of**:

    i. **Low interest rates**.

    ii. Generous and frequent **financial restructuring**.

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Overview of actions

- Authorities around the world have introduced a **flurry of emergency measures** to mitigate and slow down economic disruptions, facilitate future recovery, avert a dislocation in financial markets, and preserve financial stability.
  - ✓ **Governments are approving large relief packages**, including cash hand-outs, tax holidays, and deploying guarantees and funding resources to be intermediated by banks.
  - ✓ **Central banks are lowering policy rates**, **providing massive liquidity** support and even offering direct support to affected sectors through credit facilities and asset purchase programs.
- Countries have also undertaken **a series of regulatory and supervisory measures**, that can be grouped in:
  1. Measures that are ready **to be used under existing regulatory frameworks**.
  2. Measures that can be **applied at the discretion of the supervisor**.
  3. **Unprecedented borrower relief measures**.

Some questions arise

1. **What kind of measures are being used?**
2. **How are borrower relief measures being targeted?**
3. **How long will measures be in place?**
4. **What, if any, are the implications for loan loss classification, provisioning, and accounting?**

COVID-19-related borrower relief measures

Implementing unprecedented borrower relief measures

Focused on providing temporary debt service relief for borrowers affected by the COVID-19 pandemic by allowing suspension or postponement of payments for a specified period of time

Commonly used instrument

- **Moratoria are the most commonly used instrument**, but with many differences in overall design, scope and duration.

> Moratoria = "*a suspension of **all** principal and interest payments for a predetermined period. While the moratorium is in force, banks are prohibited from charging penalties and fees on loans to which the moratorium applies.*"

- Rescheduling and restructuring:
  - **Temporarily reduced payments**.
  - **Temporary switch to interest-only payments**.

\+

- **Extended maturities**.
- **Capitalization of deferred payments**.

Limiting the effect on borrowers' debts in NPV terms

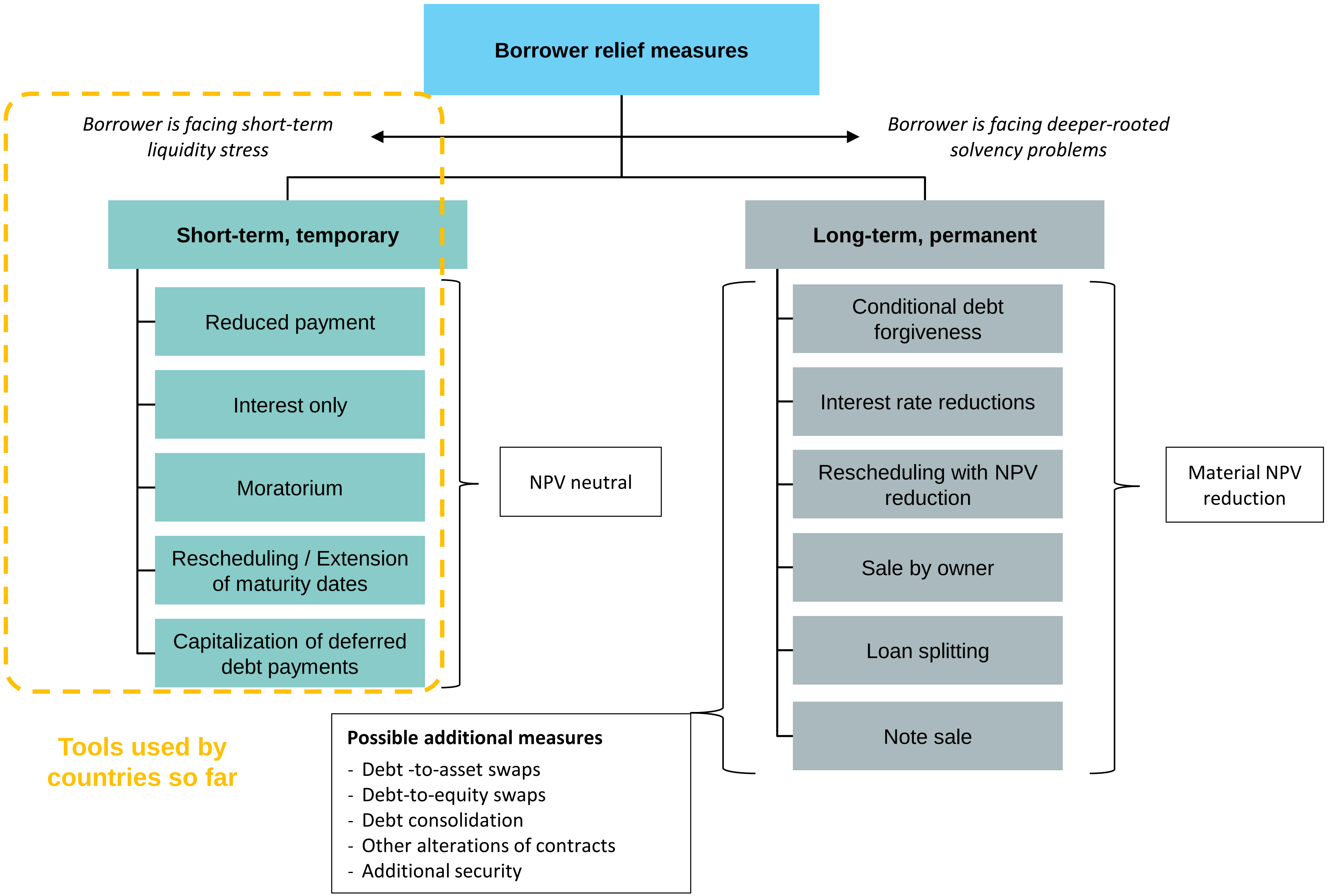
- Note that in order to fully **neutralize the effect of the deferment of debt service obligations on NPVs**:

$$\sum \begin{matrix} additional\ future \\ payments \end{matrix} \geq \sum \begin{matrix} deferred\ debt\ service \\ obligations \end{matrix}$$

- …. to account for the time value of money

COVID-19-related borrower relief measures

Borrower relief measures taxonomy



- It is **generally challenging** to distinguish between borrowers that are temporarily liquidity-distressed and those that are facing deeper-rooted solvency problems
- This difficulty is currently exacerbated by **uncertainty regarding the unwinding of emergency measures** and the **economic recovery trajectory**

COVID-19-related borrower relief measures

Targeting borrower relief measures

- Countries have generally tried to **target measures at borrowers whose debt-shouldering capacity has been severely affected by COVID-19**
    - **However, a few countries have rolled out general moratoria for all borrowers and some similar pressures in other countries.**
- Within the group of "targeters", **two different approaches can be distinguished**:

Government-initiated approaches

- Banks have a **legal obligation to execute government orders**, with detailed **instructions as to who qualifies and what type of relief is to be offered**.
- **Public guarantees** can be provided to **compensate banking sector for the risk associated with executing government policy**.
- Pros:
    - ✓ **Consistency in application**.
- Cons:
    - × **One-size fits all solutions**.
    - × **Financial impact on banks**.

Mixed approaches

- Banks are encouraged to provide borrower relief but within a less prescriptive framework that leaves **banks considerable discretion with respect to borrower selection** and relief measures offered, often with a coordinating role for banking associations.
- **Public guarantees** can be used as a tool to **incentivize risk-averse banks to provide relief to distressed borrowers**.
- Pros:
    - ✓ Allows **banks to offer tailored solutions**.
- Cons:
    - × **Consistency in application is more difficult**.
    - × **Full cooperation more difficult to ensure**.

While countries in ECA region have rolled out various kinds of public guarantees, these are generally small in scale (reflecting fiscal space limitations) and mostly designed to support new lending, rather than supporting borrower relief measures

COVID-19-related borrower relief measures

Expected duration of exceptional measures

- Countries have generally explicitly stated that the borrower relief measures are **designed to be temporary**, but – reflecting the unusually uncertain outlook – **there are considerable differences as to how long the measures are expected to be in place**.
- Most countries have established **explicit sunset clauses**
- The table below summarizes the situation end-April. Ever since, further extensions have taken place:

	Application period	Moratorium duration
Italy	N/A	Until end-September 2020 (retail mortgages)
Serbia	10 days (“refusal period”)	As long as the emergency state declared due to the pandemic is in force, but not less than 90 days
Montenegro	N/A	Max. of 90 days (no longer than decision applies)
BiH	While the Decision is in force	Maximum of 6 months
Moldova	Households: 07/31/2020 Corporates: 06/30/2020	N/A
North Macedonia	Until 30 September 2020	N/A
Kosovo	Until 30 April 2020 (extendable)	Until 30 April 2020 (but extended)
Albania	Until 31 May 2020 (extendable)	Until 31 May 2020 (extended)

COVID-19-related borrower relief measures

Pre-COVID-19: NPL and forbearance regulatory definitions harmonization

- In recent years many ECA countries embarked on EU-inspired reforms, including **aligning regulatory definitions of NPLs and forborne exposures with applicable EU standards** (mainly EBA's RTS) **and BCBS**.

Non-Performing Exposures

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Some of the criteria that have been introduced:

- **90 days past due** hard backstop (quantitative threshold).
- **Unlikeliness to pay** – UTP (qualitative criteria): regardless of the number of DPD, there is evidence that full repayment of principal and interest is unlikely without realization of collateral.
- Banks are also expected to **regularly assess the creditworthiness and repayment capacity** of their customers to identify whether UTP indicators are present.
- **Pulling effect** (20% criteria) for borrowers with multiple loans.- if more than 20 percent of the exposures of a borrower is considered an NPL, then by extension all the other exposures of that borrower should be considered an NPL as well.
- **No influence of collateral** in categorizing an exposure as non-performing.

Forbearance

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BANK FOR INTERNATIONAL SETTLEMENTS

- **Financial difficulties of the borrower prompt the lender to make concessions** (irrespective whether a loan is past due):
  - ✓ **Reduction of the actual amount to be paid**; **changes in the schedule of payments**; **granting of grace periods**; **extending maturities**; and **decreasing interest rates**.
  - ✓ Other: **granting additional loans**; **lowering collateral requirements**; **release of collaterals**; **converting debt to equity**; **deferring collections**; **forgiving, deferring, or postponing principal and interest**; etc.
- Can be included in **both the performing or non-performing category**.
- **Specific criteria** to be met before **upgrading from non-performing forborne to performing forborne**.

COVID-19-related borrower relief measures

Post-COVID-19: implications for loan loss classification and provisioning

- As a response to COVID-19, **most countries have** follow recent **EBA's and BCBS publications on prudential treatment of moratoria** and other temporary borrower relief measures.

Non-Performing Exposures

EBA EUROPEAN BANKING AUTHORITY

- Payment delays are based on a modified schedule of payments, i.e. **taking into consideration the rearranged debt obligations** after considering borrower relief measures.
- **Days past due: effectively frozen while a moratorium is in place** (because debt obligations are temporarily suspended).
- **UTP criterion**: **based on** bank's assessment whether the borrower is **unlikely to repay the rescheduled payments**.
  - Participation in a moratorium does **not mean that a borrower/loan should automatically be considered UTP**.
  - But banks should still apply the UTP criterion **to borrowers whose short-term payment challenges** are likely to transpose into **long-term financial difficulties**.

Forbearance

EBA EUROPEAN BANKING AUTHORITY

BANK FOR INTERNATIONAL SETTLEMENTS

- No requirement that loans subject to a moratorium be considered as forborne provided they **meet certain EBA requirements.**
  - ✓ Launched in **response to the COVID-19 pandemic**.
  - ✓ **Broadly and consistently applied**.
  - ✓ Apply to a **broad range of obligors**.
  - ✓ The **same moratorium offers the same conditions**.
  - ✓ **Moratorium changes only the schedule of payments**.
  - ✓ No **material NPV reduction**
  - ✓ Should **not apply to new lending**.

- With few exceptions, the 90 dpd hard backstop has been upheld…
- … but indications that the UTP criterion is not rigorously enforced…
- ... and some recent measures to avoid considering restructured loans as forborne exposures

COVID-19-related borrower relief measures

Implications for accounting – IFRS 9

In the current uncertain economic outlook:

- There are some **concerns as banks may need to**:
  - **Reclassify** a significant share of their loan book **from performing to underperforming or non-performing**.
  - **Recalibrate their credit risk parameters** to reassess their expected losses **according to the new economic expectations**.
- Both may **trigger a surge in loan loss provisions**, resulting in **sizable bank losses and capital depletion**, that would undermine their capacity to support the economic recovery with credit (“procyclicality”).

Potential tension between the need for pragmatism (to avoid a significant tightening in credit conditions) **while upholding (IFRS 9) forward-looking approach** towards recognizing and provisioning for credit losses.

It is important to highlight that:

- Participation in a **moratorium or other borrower relief measures is not automatically considered a default**.
- The **assessment whether there is a SICR is exceptionally difficult under the current circumstances**.

COVID-19-related borrower relief measures

Implications for accounting – IFRS 9: avoiding procyclicality

- Guidance from selected **agencies on IFRS 9, aimed at avoiding procyclicality** :

Guidance on avoiding procyclicality

EBA

- **Participation in borrower relief schemes** (e.g., moratoria) **should not automatically be considered a default under IFRS 9**.
- Banks should consider the **high degree of uncertainty and changes that might result in impacts over the life of financial instruments**.

ECB

- Banks should **avoid procyclical assumptions in their models and opt for IFRS 9 transitional rules**.
- Reassessments of lifetime Expected Credit Losses (**ECL**) can be **undertaken at the portfolio level**, without the need to identify which individual financial instruments have suffered a SICR.

IFRS Foundation

- Acknowledged the difficulty in incorporating the effects of COVID-19 into estimates on a “reasonable and supportable basis” but **changes in economic conditions should be reflected in macroeconomic scenarios used in those estimates**.

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Prerequisites and risks: a) Potential impact on banks' financial position

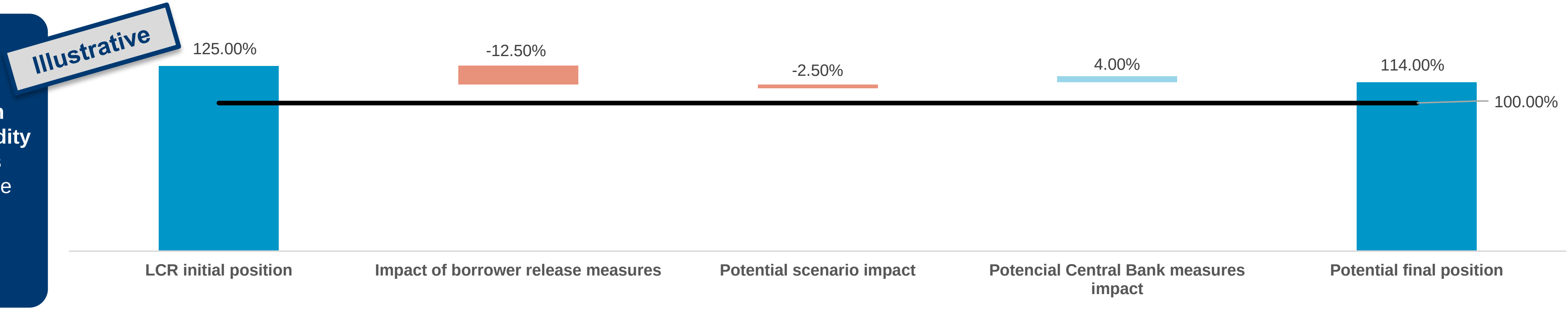
1 **Prerequisites and risks: a) Potential impact on banks' financial position**

2 High-level principles

- Even though borrower **relief measures undertaken so far** by countries in the EU and ECA region have focused on **temporary, short-term relief through the deferment of borrowers' debt obligations**, such measures can have a **significant impact on banks' financial position**.
- It is **thus critical that in designing borrower relief measures, policymakers have**:
  - Fully assessed **how the measures are likely to financially impact the banking sector** in the near term.
  - Ensured that proposed measures **do not present an unacceptable risk to banks' safety and soundness.**
  - Techniques such as **scenario analysis and stress-testing** tools might be particularly useful to gauge the impact.
- This is **particularly important under government-initiated approaches** wherein:
  - **Banks have little discretion** with respect to borrower selection and type of relief offered.
  - **Measures are designed under political pressure**, possibly without sufficient consideration for the impact on banks.

Pre-existing weaknesses in the banking system significantly reduce the capacity of the banking system to absorb the financial impact of borrower relief measures

Impact on banks' liquidity positions (sector-wide analysis)



Various scenarios shall be developed in the scenario analysis, including different timeframes and also considering impact on solvency positions

A few preliminary guiding principles

Prerequisites and risks: b) Unintended side effects

1 **Prerequisites and risks: b) Unintended side effects**

2 High-level principles

- When implementing **borrower relief measures**, policymakers shall instrument **measures to also deal with unintended side effects**. There are two main side effects that shall be considered:

	Type of borrower	Rationale	Mitigation measures
Moral hazard: "willful defaulters"	➢ Debtors **financially capable but unwilling to pay**.	➢ **Capable debtors take advantage** of borrower relief measures and weaknesses in legal frameworks (e.g., near impunity in default) **not to repay.** ➢ Significant problems with **strategic defaulters** in several countries pre-COVID-19. ➢ Adverse impact on **repayment discipline.** ➢ The **financial impact on the banking sector is magnified** if a significant number of borrowers is allowed to repay below their financial capacity.	➢ **Strengthening of legal framework and insolvency frameworks** (many reforms initiated in ECA region post-GFC). ➢ Require that banks offer borrower relief measures to clients financially impacted by COVID-19 (while leaving the selection to banks).
Zombie borrowers	➢ Companies that are **unable to cover debt servicing costs** from current profits over an extended period. ➢ Debtors already in **difficulties prior to COVID-19**.	➢ Borrowers likely **try to get a fresh lease of life** through borrower relief measures. ➢ Risk is that the credit stock is locked up in stagnant and **underperforming economic sectors that continue to drive the demand for credit at the expense of more dynamic borrowers**. ➢ Allocative inefficiency.	➢ Limit measures to **borrowers with a sufficiently strong repayment track record prior to the outbreak of COVID-19**. ➢ **Exclude** borrowers with **loans already classified as NPLs at the onset of COVID-19**.

A few preliminary guiding principles

High-level principles: 1. Targeting

1 Prerequisites and risks

2 **High-level principles 1. Targeting**

- Most ECA countries **have set up schemes with the explicit objective of supporting borrowers whose repayment capacity has been negatively affected by COVID-19** ("targeting").
- **Most countries have opted for mixed approaches**, leaving banks some discretion in selecting borrowers.
- **Italy and Turkey** have specified upfront that relief measures are **only available to certain types of borrowers** (e.g. retail mortgages and SMEs in Italy).

		Italy	Serbia	Montenegro	BiH	Moldova	North Macedonia	Kosovo	Albania	Turkey
Target initiation	Government	✓	✓	✓	✗	✗	✗	✗	✗	✗
	Mixed	✗	✗	✗	✓	✓	✓	✓	✓	✓
Upfront requirements to which borrowers measures are available?	No	✗	✓	✓	✓	✓	✓	✓	✓	✗
	Yes	✓	✗	✗	✗	✗	✗	✗	✗	✓

Borrower relief measures have been generally set only for the outstanding credit stock

High-level principles: 1. Targeting (cont.)

1 Prerequisites and risks

2 **High-level principles 1. Targeting**

- Most ECA countries **have set up schemes with the explicit objective of supporting borrowers whose repayment capacity has been negatively affected by COVID-19** ("targeting").
- Targeting has potential benefits, but it is critical that **speed in delivery is not compromised.**

Pros

- **Mitigates moral hazard** by borrowers.
- **Mitigates financing zombie borrowers**.
- Keeps **financial impact on banks** within **manageable proportions**.

Cons

- Can inadvertently introduce **delays in the provision of relief measures to distressed borrowers**.

Potential balanced option:

- Practical approach, avoid cumbersome verification processes and excessive detail in requirements
- Policymakers / **banking regulators**: may in general terms **require that relief measures benefit borrowers that are adversely affected by COVID-19**.
- **Banks**: keep **discretion on how the assessment is conducted** and with light-touch monitoring of practices through day-to-day supervision.
- Upfront requirement can be set that borrowers benefitting from relief measures need to have a **sufficiently strong payment track record prior to COVID-19.**

A few preliminary guiding principles

High-level principles: 2. Exit strategies

1 Prerequisites and risks

2 **High-level principles 2. Exit strategies**

Temporary nature

- Borrower relief measures are of a **temporary nature** and they will be unwound as soon as circumstances allow.
- Most countries have clearly communicated **upfront sunset clauses**.
- There is the need to **avoid that measures constitute a "new normal"**, making it increasingly difficult to revert to the status quo pre-COVID-19

Exit strategies

- **Policymakers need to prepare and set exit strategies**, to develop a view on the circumstances in which the exceptional measures can be unwound.
- The **circumstance could include**, among others: a clear **indication that the pandemic is under control**; **suspension of emergency measures** to stop the spread of the disease; or a **sustained period of positive economic growth**.

Public communication

- **Public communication** about these preconditions for **revoking the borrower relief measures is important to manage expectations**.
- It ensures that the **temporary nature** of the measures is **well understood by borrowers and banks alike**.

High-level principles: 3. Supervisory reporting and transparency

1 Prerequisites and risks

2 **High-level principles: 3. Supervisory reporting and transparency**

It is essential that **banks produce reliable, frequent, up-to-date, and comparable information** regarding loans that have benefitted from **borrower relief measures** (as is the case for any rescheduled loan).

1. Banks should be required to **tag loans that have benefitted from borrower relief measures**, **perform periodic assessments**, and **report a set of standard indicators for assessing the credit risk of such loans** (e.g., collateral and repayment behavior).

2. A periodic reporting to **policymakers to assess whether the measures are having the desired effect**, and to **banking supervisory agencies to be able to closely monitor the impact on banks**' asset quality, capital, and overall financial standing.

   A **balance between specificity and simplicity needs to be achieved**, aimed at avoiding unnecessary administrative burdens on banks.

3. **Bank depositors, investors and shareholders** must have **access to reliable, updated and consistent** financial information about **banks' exposure to credit risk**, in order to inform their decisions, also related to **borrower relief measures**.

Illustrative

Form COV-RM

Report on restructured loans and loans under moratorium in accordance with interim measures

EUR 000

No.	POSITION	Total number of debtors	Number of sub-accounts	Amount
1.	RESTRUCTURED LOANS			
1.1.	Natural persons			
1.2.	Entrepreneurs			
1.3.	SME up to EUR 100 thousand			
1.4.	SME over EUR 100 thousand			
1.5.	Other business undertakings			

2.	RESTRUCTURED CASH UNSECURED LOANS	Total number of debtors	Number of sub-accounts	Amount
2.1.	Natural persons			

3.	MORATORIUM	Total number of debtors	Number of sub-accounts	Amount
3.1.	Natural persons			
3.2.	Entrepreneurs			
3.3.	SME up to EUR 100 thousand			
3.4.	SME over EUR 100 thousand			
3.5.	Other business undertakings			

Note:

Loans shown under #1 do not include loans shown under #2.

A few preliminary guiding principles

High-level principles: 4. Upholding loan loss classification, provisioning and accounting requirements

1 Prerequisites and risks

2 **High-level principles:**
4. Uphold loan loss classification, provisioning and accounting

- Over the past years, many countries in ECA have undertaken a considerable effort to **align regulatory definitions of NPLs and forborne exposures with EBA and BCBS standard**s
- In our view, it is important to **protect these hard-won gains** of the last years
- In the paper, we **advise against a relaxation of regulatory definitions for NPLs and forborne exposures** and classification and provisioning requirements.
- Stretching regulatory definitions for NPLs and forborne assets:
  - **Undermines market discipline and comparability** within and **across countries**.
  - **Distorts the veracity of financial information** and blurring the distinction between borrowers negatively affected by COVID-19 and zombie borrowers.
  - These measures are **difficult to unwind**, as industry pressures will likely resist the prospect of recognizing a significant spike in NPLs and the corresponding increase in provisioning charges.

Policy Note “**Borrower Relief Measures in ECA Region**” is available:

- on the FCI internal website (link);
- on the FinSAC website (link).

Thank you!