

# When and how to unwind COVID- support measures to the banking system?

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## **Abstract**

This paper examines regulatory measures and supervisory practices that have supported public guarantee schemes and moratoria in euro-area countries. The focus is on flexibility shown with regard to default classifications, accounting practices and the treatment of non-performing loans. The paper identifies a number of undesirable effects and examines how soon such policies can be normalised.

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## LIST OF ABBREVIATIONS

<b>BCBS</b>	Basel Committee of Bank Supervisors
<b>CET1</b>	Common equity tier 1
<b>CRR</b>	Capital Requirements Regulation
<b>EBA</b>	European Banking Authority
<b>ECB</b>	European Central Bank
<b>IAS</b>	International Accounting Standard
<b>IASB</b>	International Accounting Standards Board
<b>IFRS</b>	International Financial Reporting Standard
<b>NPL</b>	Non-performing loan
<b>PEPP</b>	Pandemic emergency purchase programme
<b>SICR</b>	Significant increase in credit risk
<b>SME</b>	Small and medium-sized enterprise
<b>TLTRO</b>	Targeted longer-term refinancing operation

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## EXECUTIVE SUMMARY

The euro-area banking system lent crucial support to the stabilisation of economies during the first set of pandemic-related lockdowns in 2020. Despite intense risk aversion in financial markets, lending standards eased and credit expanded in mid-2020, benefitting small and medium-sized enterprises (SMEs) in particular. This credit expansion prevented the premature scarring of economies and the insolvencies of firms that, at the time, faced liquidity shortages, but no solvency issues yet. By the third quarter of 2020, the still extensive payment moratoria covered 6.4 percent of the euro-area corporate loan stock, and an even larger share of SME loans. At the end of 2020, public loan guarantees covered between 1 and 8 percent of GDP in the four largest euro-area countries, explaining most of the credit growth in the currency union over the year. These loan portfolios will inevitably be associated with substantial credit risk, though this may only materialise once supportive policies are phased out.

National credit-support measures have depended in large measure on enabling policies adopted in European regulation, and by the European Central Bank (ECB) and other supervisors, alongside the various capital relief measures and liquidity operations. Supportive measures have taken the form of amendments to EU regulation (for example, the extended IFRS 9 transitional arrangement), supervisory policy (as in the European Banking Authority (EBA) moratoria guidelines) and interpretive statements (e.g. on the default definition).

While essential at first, these supportive measures put three interrelated policies on credit risk in the euro-area banking system at risk: transparent reporting of banks' asset quality and loan defaults; the recognition of forward-looking credit losses under the IFRS 9 accounting framework; and the scrutiny of banks' management of non-performing loans (NPLs), and their reduction to acceptable levels.

This paper reviews how these three aspects of supervisory policy have changed over the course of the pandemic. There have been no meaningful amendments to the substance of regulations, though the European Commission, EBA and ECB signalled flexibility early on in terms of their interpretation. A question remains over the implementation of the accounting framework IFRS 9. Euro-area banks' overall provisions over the course of the crisis are below those in other advanced markets and fell again in the second half of the year. Idiosyncratic borrower-level risk assessments have fallen behind collective provisions, which may undermine banks' ability to identify and offer restructuring solutions in the recovery.

Policy support to banks is now limited, or in any case set to be phased out, in particular with the favourable treatment of moratoria ending in March 2021. Existing definitions of default and forbearance should not be amended, as this would undermine the transparency of loan quality reporting more broadly. As banks have not sufficiently scrutinised credit risk in individual borrowers, the ECB's closer monitoring of banks' practices in this area, which was announced in December 2020, was overdue. Targets for NPL reduction will need to be revisited, and should be established in light of liquidity in the markets for collateral, and desirable restructuring outcomes for still viable borrowers.



## 1. INTRODUCTION

In March 2020, the European economy entered a sharp downturn because of the imposition of various lockdowns related to the COVID-19 pandemic. From the onset of this recession the objective of Member States and the ECB was to support European firms and jobs through the continued provision of credit, backing up various other national fiscal measures, such as wage-subsidy schemes, grants and tax deferrals. Member States designed large support packages, relying on loan moratoria and lending guarantees, targeted in particular at small businesses. These schemes were flanked by the release of capital buffers and various other supervisory measures which augmented banks' capital headroom. Supervisors supported these moratoria and loan guarantee programmes so that national credit support measures would not translate into defaults and loan losses unwarranted by underlying solvency problems. A substantial expansion in credit to enterprises in Q2 2020 appears to have borne out the wisdom of this policy (ECB, 2020).

In early 2021, supervisors and market participants are left with one major conundrum: Europe's deepest recession in a generation has, as yet, only resulted in a minor increase in euro-area non-performing loans, and a further fall in the NPL ratio. This briefing paper addresses the questions of whether the flexibility granted in regulations and supervision has undermined the credibility of asset quality disclosures by banks, and when and how support should be withdrawn.

We focus on one aspect of supervisory policy that has elicited the most concern among market participants: the apparent tolerance for greater credit risks on bank balance sheets and the possible obscuring of the true deterioration in terms of risks in euro-area banks. As some commentators allege, this stance of European regulators and supervisors is evident in the delayed recognition of lower asset quality and NPL reporting, the relaxation of accounting standards that should have required the early recognition of expected losses, and tolerance for higher NPL levels within banks. Based on EBA figures for September 2020, an estimated 6.4 percent of euro-area banks' corporate loans were covered by moratoria, with a significantly larger share in the case of SMEs (EBA, 2021a). If a forbearance or default classification under regular asset quality standards were to be abruptly reintroduced, banks would face 'cliff-edge' risks of a sudden deterioration in asset quality, and an excess of corporate loans due for financial restructuring or disposal.

Supportive treatment in supervision avoided excessive volatility in provisions at the onset of the crisis, as bank capital was strengthened, for instance, through the suspension of dividend payments. Nevertheless, the flexibility allowed during the pandemic may have undermined the transparency and credibility of European accounting and loan quality standards. These standards were key successes in the regulatory reform following the previous financial crisis. Moral hazard and a culture of forbearance could again take hold among banks.

To assess the potential costs to asset quality accounting from past policy, this paper proceeds as follows: section 2 documents how national loan moratoria and guarantee schemes have underpinned the expansion of credit in 2020. Section 3 examines to what extent this credit expansion depended on favourable treatment under regulations or supervision, and identifies the 'cliff edge' risks that could result from an abrupt suspension of such favourable treatment. Section 4 then examines three aspects of supervisory support for credit programmes: first, the easing of the default classification, and related loan quality standards; second the further delay to the full reflection of expected credit losses in banks' regulatory capital as would be required under the IFRS 9 standard; and third, the apparent tolerance by supervisors of higher NPL levels at both country and bank level. Section 5 concludes with a number of proposals for supervisory policy during the recovery.

## 2. THE 2020 CREDIT EXPANSION

The credit expansion in the euro area in 2020 was a striking contrast to the contraction in credit experienced in the year to early 2010, when credit to enterprises in the euro area fell by 4 percent<sup>1</sup>. In early 2020, at a time of intense risk aversion, a similar liquidity contraction as in the previous crisis could have resulted in destructive second-round effects in the credit markets. A central ambition of ECB prudential and monetary policy measures was to counteract the COVID-19-related shock by rapidly widening banks' refinancing conditions and granting capital relief.

The ECB and national central banks expanded their liquidity programmes, including the European Central Bank's targeted longer-term refinancing operations (TLTRO) III and the pandemic emergency purchase programme (PEPP). Crucially, the ECB package of measures announced on 12 March 2020 allowed banks to operate below capital levels previously agreed in the so-called Pillar 2 process<sup>2</sup>. Jointly with other measures, such as release of capital buffers and dividend restrictions, the capital headroom ultimately expanded by about 2.5 percentage points (ECB, 2021). The release of capital buffers of more than €120 billion substantially expanded banks' lending capacity. Estimates at end-2020 suggest that even after credit impairments that materialised up to October, euro-area banks had €300 billion in headroom for lending to households, and €900 billion for lending to enterprises (IMF, 2020).

In parallel, regulators and supervisors accommodated the various national moratoria and publicly guaranteed credit schemes, which were rapidly established in member states during the first wave of lockdowns. The aim of member-state programmes was to maintain adequate liquidity for businesses and households, and to mitigate the immediate impact of the sudden freeze in economic activity.

### 2.1. Moratoria and public guarantees schemes

Given the significant credit risks inherent in national moratoria and guarantee schemes, the EBA imposed comprehensive reporting requirements on banks<sup>3</sup>. All euro-area countries had such a scheme in place at some point over the course of 2020, either on the basis of legislation, or by encouraging the industry to offer it. €574 billion in loans benefitted from payment relief at end-September in 2020, and a further €345 billion was covered by schemes that had previously expired. By mid-2020, moratoria accounted for more than 10 percent of total credit outstanding in 10 euro-area countries (EBA, 2020; also including Bulgaria and Croatia in this group). Under the EBA guidelines, moratoria eligible for favourable treatment had to be offered regardless of creditworthiness. With only the exception of Ireland, Table 1 indeed shows NPL levels of portfolios covered by moratoria that were lower or in line with the general loan portfolios. Banks made a substantial number of risk assessments for borrowers (the so-called stage 2 under IFRS 9). Nevertheless, for a substantial part of the credit stock, banks have essentially been blind to arrears, which normally function as the first signal of deterioration in credit risk. Under the revised EBA Guidelines of December 2020, moratoria were in principle allowed to be in place until end-March 2021 and to offer payment relief to borrowers for up to nine months. Whether normal payment patterns resume thereafter may not be fully clear until end-2021.

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<sup>1</sup> Based on BSI data in the ECB Statistical Data Warehouse for the drop in credit between February 2009 and April 2010.

<sup>2</sup> ECB [press release](#) of 12 March.

<sup>3</sup> Notifications by supervisors of current [moratoria](#) and [guarantee schemes](#) are available on the EBA website.

Table 1: Loans and advances with non-expired EBA-compliant moratoria, Sept. 2020

	Total (EUR bn)	of which to HH	of which to NFCs	% of loans in stage 2		NPL-ratio	
				under moratoria	overall	under moratoria	overall
AT	22.7	50.2%	48.6%	38.3%	17.6%	2.8%	2.0%
BE	25.9	37.3%	60.2%	32.3%	11.2%	1.7%	1.9%
DE	8.3	52.0%	46.3%	16.6%	6.8%	1.7%	1.2%
ES	83.8	72.5%	27.3%	17.9%	6.0%	3.9%	3.0%
FR	131.2	13.6%	85.2%	12.8%	7.1%	1.6%	2.3%
GR	22.2	43.3%	55.5%	32.0%	12.9%	17.5%	28.8%
IE	10.7	41.2%	58.2%	36.8%	14.4%	11.4%	4.0%
IT	151.7	31.5%	65.6%	22.4%	11.4%	1.1%	5.4%
NL	36.7	22.0%	76.8%	29.1%	8.1%	2.4%	1.9%
PT	46.0	45.9%	53.8%	17.3%	9.3%	6.1%	5.5%

Source: Bruegel, based on EBA Q3 Risk Dashboard. Note: HH = households, NFC = non-financial corporations. The 182 institutions reporting to the EBA account for about 80% of the total assets of the EU banking sectors, though there are important variations across member states. Exposures also include loans to counterparties of all regions that have granted moratoria and for some countries, exposures may be driven by banks' presence in other countries through their subsidiaries. 'Stage 2' refers to the higher risk classification under the IFRS 9 accounting framework.

Public guarantee schemes have been a key tool to mobilise additional lending, benefitting in particular SMEs, and by end-September 2020, €288 billion in credit had been originated under such schemes, according to EBA figures. However, these schemes were heavily concentrated in just four countries (France, Italy, Germany and Spain), which together accounted for 93 percent of publicly guaranteed loans in the EU Member States (Table 2 lists the ten largest Member States). Anderson *et al* (2021) offer detailed evidence on public guarantee schemes in these four countries. The announced headline numbers for public guarantees were substantial (between 12 and 22 percent of GDP), though actual usage was considerably lower. By August 2020, usage of the schemes had topped out in all but Italy, and figures reviewed in that study suggest guaranteed loans at 8 and 9 percent of GDP in Italy and Spain respectively, though only at 1 percent in Germany. Guaranteed credit accounted for more than half of new credit generated in the second quarter of 2020 in France and Spain, though somewhat less in Italy (35 percent) and Germany (16 percent)<sup>4</sup>.

Credit guarantees were made possible by the exemption from EU state aid rules. Even though, normally, public guarantees on non-market terms would be prohibited under state aid rules, when the Commission invoked a serious disturbance in March 2020 under TFEU Art. 107 (3) (b), a wide-ranging exemption became possible.<sup>5</sup> The Temporary Framework facilitated speedy processing of national credit guarantee programmes and related state aid notifications based on this provision. This nevertheless defined an important constraint, as borrowers already deemed to be in financial difficulty under Commission guidelines would not be eligible for guarantees. In essence, non-performing loans that emerge from these programmes could be attributed to debt distress that arose during the pandemic. Also, the maturity of guaranteed loans would be limited (38 percent were of maturities of between 2 and 5 years). Coverage of new loans will end with the expiry of the Temporary Framework, which is expected to happen in December 2021.

<sup>4</sup> EBA figures, which are based on a survey of 182 banks, substantially fall short of those reported by national promotional banks for total guaranteed volumes.

<sup>5</sup> EU Commission Press Release of 19 March 2020: "Commission adopts Temporary Framework to enable Member States to further support the economy in the COVID-19 outbreak".

Table 2: Newly originated loans and advances subject to public guarantee schemes, Sept. 2020

	Total (EUR bn)	guarantee received	% of loans in stage 2		NPL-ratio	
			under PGS	overall	under PGS	overall
AT	2.8	71.8%	31.3%	17.6%	0.7%	2.0%
BE	0.9	29.3%	5.1%	11.2%	0.2%	1.9%
DE	7.8	79.1%	7.5%	6.8%	0.5%	1.2%
ES	92.1	78.3%	2.3%	6.0%	0.2%	3.0%
FR	115.4	53.1%	5.6%	7.1%	1.4%	2.3%
GR	2.7	64.9%	1.0%	12.9%	0.3%	28.8%
IE	0.4	76.2%	3.2%	14.4%	4.5%	4.0%
IT	56.8	81.6%	5.1%	11.4%	0.1%	5.4%
NL	1.9	84.8%	22.5%	8.1%	3.0%	1.9%
PT	5.8	81.1%	7.1%	9.3%	0.2%	5.5%

Source: Bruegel, based on EBA Q3 Risk Dashboard. Note: PGS = public sector guarantees. See Table 1 for limitations related to EBA data. Further note that the figures may omit 100% loan guarantees since EBA banks applying the IFRS might derecognise loans that are fully guaranteed.

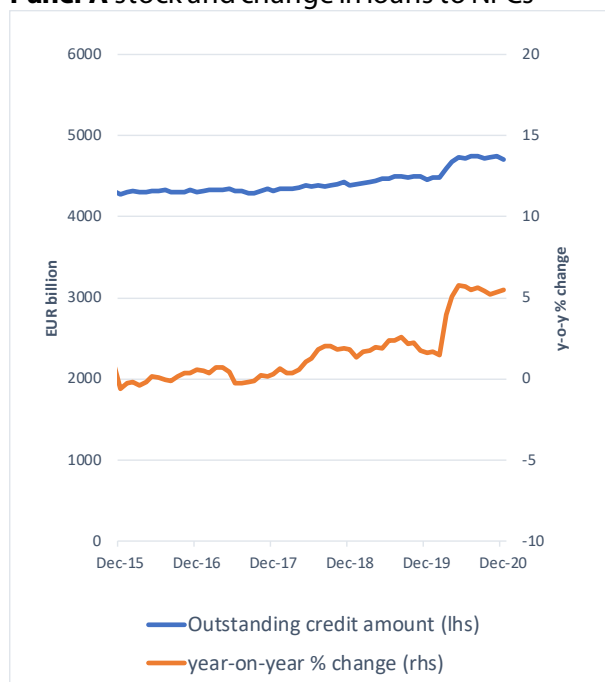
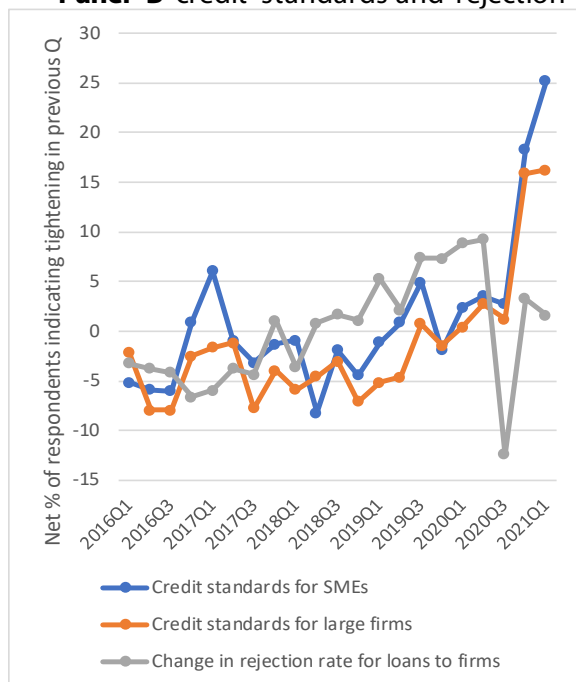
## 2.2. Lending standards and risk perceptions

National credit guarantee schemes explain the bulk of the expansion in euro-area credit to enterprises that was observed in the second and third quarters of 2020 (Figure 1, Panel A). The various schemes, together with the support signalled by the ECB at the onset of the crisis, even contributed to a slight easing of credit standards applied to corporate credit in the second quarter. In parallel, there was a sharp drop in the rejection rate of loan applications, as banks took only modest own risk positions in credit generated under the guarantee schemes (Figure 1, Panel B).

Banks' relative openness to new corporate lending business however reversed quickly, and by the second half of the year, banks again tightened credit standards for enterprises. Banks signalled that their perception of risk related to the economic outlook and reduced risk tolerance were the key factors that explained tightening of credit standards in the second half of the year, and they expected this trend to continue in the first half of 2021 (Figure 1, Panel B)<sup>6</sup>. Banks seemed well aware of the risks that were building up. Expectations of non-performing loans in the corporate loan book explained a large part of the tightening, even though by until the end of the third quarter, NPL volumes had edged up only slightly, and the NPL ratio for euro-area banks had in fact fallen further to 3 percent (EBA, 2021b).

<sup>6</sup> ECB Bank Lending Survey, January 2021.

Figure 1: Credit to non-financial companies in the in the euro area

**Panel A** stock and change in loans to NFCs**Panel B** credit standards and rejection rate

Source: Bruegel, based on ECB Statistical Data Warehouse.

### 3. SUPPORTIVE MEASURES IN EU REGULATION AND ECB SUPERVISION

Loan moratoria and public guarantee schemes ran a clear risk of triggering default and forbearance classifications under EU rules for asset quality. Even though banks benefitted from substantial guarantees from national governments (in some instances up to 100 percent of the exposure) there was a danger that at a time of intense risk aversion, lenders would not take on even minor additional risk exposures, and a credit crunch would ensue.

Based on the original terms of the Capital Requirement Regulation (CRR), publicly guaranteed credit was in principle attractive to lenders, as the guaranteed portion of the exposure would be subject to a risk weight of zero. An evaluation by the EBA found that guaranteed loan portfolios in Italy and Spain were subject to average risk weights of 9 and 12 percent respectively, compared to, on average, 54 percent for non-guaranteed exposures (EBA, 2020). Moreover, the statutory provisioning requirements were also pushed back<sup>7</sup>. This already presented strong incentives to the industry: lenders earned interest income on the full loan while having to mobilise capital only on the portion of the loan not covered by the guarantee.

To address the risks arising from the loan quality definitions and the potentially pro-cyclical provisioning charges, the Commission, the ECB and the EBA issued a number of communications, press releases and statements. These supported the implementation of national credit support programmes

<sup>7</sup> This aligned the minimum coverage requirements for non-performing exposures that benefit from guarantees granted by national governments or other public entities with those for non-performing exposures that benefit from guarantees granted by official export credit agencies, which is 0 percent for the first seven years.

and eased a number of existing regulatory and supervisory reporting requirements, though more recent statements have scaled back some of the implied support.

### 3.1. Treatment of moratoria

Already in March 2020, the EBA issued a statement on the application of the prudential framework in the context of member states' COVID-19 measures<sup>8</sup>. The EBA Guidelines in early April then clarified more fully that moratoria that meet a number of criteria, crucially that they would not differentiate by credit quality of the borrower, should not be considered as forbearance measures. Moratoria would suspend the usual 90 days arrears deadline, beyond which a borrower would normally be considered to have defaulted<sup>9</sup>. Also, borrowers taking advantage of the moratorium would not automatically be considered “*unlikely to pay*” (which, under Art. 178 of the CRR, would also trigger a default). Banks were nevertheless encouraged to assess each borrower individually, so that actual solvency problems could be identified. In an attempt to enable supervisors and the markets to keep track of each firm's exposure, further guidelines imposed additional reporting and disclosure obligations.

This blanket exemption was phased out in September 2020, though then reinstated in December as the second wave of COVID-19 gathered pace and member states imposed new lockdowns. This revised guideline is now in place until end-March 2021<sup>10</sup>. Regarding new moratoria, this revised statement contained two important safeguards. Loans could not benefit from payment holidays for more than nine months in total; and banks would need to report to their supervisors, and disclose to the market, their strategies for assessing whether loans would become ‘unlikely to pay’.

### 3.2. The ‘quick fix’ of the Capital Requirements Regulation

The Commission issued a first communication in April 2020, shortly after the EBA Guidelines<sup>11</sup>. This contained a long section on how banks should judge a significant increase in a borrower's credit risk, which would force the booking of expected credit losses. This was presented as an elaboration of the original accounting framework (IFRS 9), and indeed a number of notes from the International Accounting Standards Board (IASB) were cited to underline this. A substantive change then came in the so-called ‘quick fix’ (EU 2020/873) to the CRR which became effective two months later<sup>12</sup>. The amended regulation provided capital relief to banks through a number of measures, brought forward already planned more favourable treatment of banks' SME exposures, and eased a number of disclosure requirements. Minimum provisioning expectations for NPLs covered by public guarantees would only apply after seven years. The regulation also extends by two years to 2024 the transitional period under IFRS 9 during which expected losses from exposures that are not already credit-impaired would not impact regulatory capital.

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<sup>8</sup> [Statement on the application of the prudential framework regarding default, forbearance and IFRS 9 in light of COVID-19 measures](#), of 25 March.

<sup>9</sup> [Guidelines on legislative and non-legislative moratoria on loan repayments in the light of COVID-19 crisis](#) of 2 April 2020.

<sup>10</sup> [Guidelines amending guidelines EBA/GL/2020/02](#).

<sup>11</sup> Interpretative Communication on the EU's accounting and prudential frameworks (“[Supporting businesses and households amid COVID-19](#)”) of 28 April 2020.

<sup>12</sup> The CRR ‘quick fix’, i.e. Regulation (EU) 2020/873 of the European Parliament and of the Council of 24 June 2020 amending Regulations (EU) No 575/2013 and (EU) 2019/876 as regards certain adjustments in response to the COVID-19 pandemic (OJ L 204, 26.6.2020, p. 4–17).

### 3.3. ECB supervision

The interpretations of the EU prudential framework by the EBA and Commission were quickly reflected in ECB supervision of the largest banks. The updated statement of its policy cites the EBA Guidelines on moratoria, as the ECB would not deem loans covered by moratoria as having defaulted. Still, it expects banks to report on how they would assess the creditworthiness of borrowers covered by moratoria<sup>13</sup>. The updated stance on accounting standards and loan loss charges also reiterates messages given earlier by the Commission. Banks are encouraged to take advantage of transitional arrangements under IFRS 9 and use long-term macroeconomic forecasts, based on reliable sources, such as the ECB itself. However, the updated policy on credit risk management which was communicated to banks in December 2020, represented a significant departure from the relative flexibility signalled by the Commission earlier in the year<sup>14</sup>.

The ECB also announced that it would be flexible in its treatment of banks' implementation of non-performing loan reduction strategies, and would consider measures such as adjusting timetables, processes and deadlines, on a bank-by-bank basis:

*"The ECB is fully aware that current market conditions may make the agreed reduction targets difficult to attain and somewhat unrealistic. In this vein, the [Joint Supervisory Teams] will be fully flexible when discussing the implementation of NPL strategies on a case-by-case basis."*

In July 2020, it also announced that the submission by high-NPL banks of NPL strategies could be postponed to end-March 2021<sup>15</sup>.

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<sup>13</sup> Based on [FAQs on ECB supervisory measures in reaction to the coronavirus](#) (Update of 1 February 2021), which updates the initial policy statement of 20 March 2020 "[ECB Banking Supervision provides further flexibility to banks in reaction to coronavirus](#)".

<sup>14</sup> ECB [Letter to CEOs of significant institutions](#), 4 December.

<sup>15</sup> ECB Press Release of 28 July 2020: "ECB extends recommendation not to pay dividends until January 2021 and clarifies timeline to restore buffers".



## 4. THE WITHDRAWAL OF SUPPORTIVE MEASURES

The extension of national credit support measures and their accommodation in regulation and supervision has lent crucial support to macroeconomic stabilisation since the onset of lockdowns. Withdrawal of these measures could lead to 'cliff-edge' risks.

A first type of risk results from the expiry of moratoria and a sudden recognition of defaults and associated loan losses. A check on the moratoria notified to the EBA by early 2021 suggests that of the 60 moratoria in euro-area countries and Croatia and Bulgaria, all but three (in Spain, Slovakia and Lithuania) had closed to new applications by end-2020<sup>16</sup>. Payment relief was generally granted to borrowers for between six and nine months, though in some cases, this was extended to 18 months. Under the renewed EBA guidelines, moratoria may be offered until end-March and payment holidays offered for up to nine months. That said, the expectation is that most borrowers that previously benefitted from a payment holiday will need to resume normal debt service by Q2 2021. Risk from the end of public guarantee schemes seems more limited. Analysis of the four key countries, which were examined by Anderson *et al* (2021), suggests that, with the exception of Italy, little additional credit has been generated under these schemes since late summer 2020 and most programmes allow a grace period of at least one year.

Loans covered by these national support schemes have been sheltered in different ways from the usual assessments of forbearance and loan default. Ending this privileged treatment carries the risk that large volumes of loans will be flagged as forborne in asset-quality reporting, or as having incurred a significant increase in credit risk. Following the end of payment holidays under national moratoria, a large share of loans could trigger default criteria and hence be classified as non-performing. This could result in sudden spikes in loan loss provisions, eroding capital and lending capacity, and undermining continued credit provision. At that point, banks risk being overwhelmed by loan exposures in the early stages of default when active and individual restructuring measures would be required, as set out in the current ECB guidance to banks.

A second type of policy risk is therefore that the abrupt change in the favourable treatment of credit support schemes under EU and ECB supervision could trigger the reclassification of a large number of loans. We now examine three adverse effects arising from such supportive policies, and then turn to policy issues in EU regulation and supervision in the concluding section.

### 4.1. Transparent reporting of asset quality

The 2014 EBA asset quality standard represented an important change in how banks report the status of their loan books<sup>17</sup>. Until that point, NPL figures reported by individual national supervisors were not really comparable, which undermined the assessment of prudential soundness in the euro-area banking sector. The new EBA standard was based on the earlier definition of default, according to which a loan would be deemed non-performing if it had been in arrears for 90 days or the lender assessed the borrower as 'unlikely to pay'. Also, the definition of forbearance (loan restructuring) was widened, and the conditions under which a restructured loan could again be classified as performing were narrowed. The 'evergreening' of loans that were in essence non-performing was no longer possible. This common understanding of the loan quality definition was an essential pre-condition for the credibility of the 2014 Comprehensive Assessment of the euro-area banking sector. In 2017, the

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<sup>16</sup> Based on the moratoria reported to the EBA by mid-February 2021, based on the [EBA website](#).

<sup>17</sup> EBA (2014): [Implementing Technical Standard on Supervisory Reporting \(Forbearance and non-performing exposures\)](#).



Basel Committee of Bank Supervisors (BCBS) introduced an asset quality standard which closely resembled the earlier European template. As other national supervisors outside the EU have also introduced this standard, international reporting on non-performing loans has become more comparable.

The new EBA asset quality definition also facilitated the better disclosure of NPL data. The so-called Pillar III approach of the Basel accord aims to enforce market discipline on the basis of good disclosure by banks to the market. NPL figures, alongside the usual flow of loan loss provisions, were seen as a crucial element of such disclosure. Under normal practice, all EU banks need to disclose to the market NPLs and forbore exposures, though more detailed disclosure is required for the largest banks with an NPL ratio above 5 percent<sup>18</sup>. Even in the standard disclosure, considerable detail is required, for instance on how many times a loan has been restructured, or which part of the portfolio failed to meet the criteria for exit from the 'cure period'.

The EBA Guidelines on the treatment of moratoria have weakened the usual asset quality and disclosure standards, at least temporarily, for two reasons:

- First, loans that benefited from moratoria were not classified as 'forborne' and hence did not as yet show in NPL figures. This classification is in principle required whenever a lender offers more generous terms and where this is justified by the borrower experiencing financial difficulties. Under normal conditions, a payment break offered under a moratorium (whether legislative or otherwise) to a borrower with imminent liquidity problems should trigger this classification. Yet, the EBA Guidelines for general payment moratoria offer a blanket exemption, while the borrower is subject to a moratorium. The full extent of such distressed restructurings will hence only become apparent when payment relief expires.
- Second, under the EBA asset quality standards, an exposure to a borrower that is assessed as 'unlikely to pay' should also ordinarily be classified as non-performing. Such an expectation by the lender about the impending inability to service a contractual loan obligation is one of the conditions that define default (in line with Art. 178 of the CRR), others being arrears exceeding 90 days, a distressed restructuring, or filing for bankruptcy. The EBA Guideline states that the borrower utilising a moratorium, or the drawing of a new loan under a public guarantee scheme, should not necessarily imply such a likely default.

The EBA's initial statement on default and forbearance and its revised Guideline on moratoria exhort banks to nevertheless perform checks on borrower soundness and anticipate situations of unlikeliness to pay. This was echoed by the ECB on multiple occasions throughout 2020<sup>19</sup>.

The expiry of the moratorium exemption, coupled with the nine-month cumulative cap on payment holidays, have now set a clear end point for this favourable treatment. Where banks exceed the total cap on payment relief, loans would need to be classified as forbore or indeed defaulted. The EBA has also mandated that banks disclose every six months loans that are subject to forbearance measures under national pandemic-related policies, and also new loans under public guarantees. The transparency of asset quality disclosed by banks has suffered, though this was perhaps inevitable given the exceptional severity of the shock, and the ensuing uncertainty.

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<sup>18</sup> These disclosure requirements are specified in the Capital Requirements Regulation (Part 8 of the CRR II), and the EBA has issued guidelines on this aspect in 2018: [Guidelines on disclosure of non-performing and forbore exposures](#).

<sup>19</sup> For instance in the ECB letter to significant institutions: Operational capacity to deal with distressed debtors in the context of the coronavirus (COVID-19) pandemic, 28 July 2020.

## 4.2. Sound risk management

Credit loss provisioning was one of the many weaknesses exposed by the 2008 global financial crisis. Prior to the implementation of IFRS 9 (under IAS 39), the accounting regime was based on ‘incurred credit losses’. However, provisions based on IAS 39 ahead of the financial crisis were generally considered too little too late. Even as risks built up, bank capital was largely unaffected.

IFRS 9 as a new accounting framework delivered on the ambition that governments spelled out in the immediate aftermath of the crisis: the accounting treatment of bank credit losses should dampen pro-cyclical lending. Banks should put in place more substantial provisions against credit losses when times are good and do so much earlier in the credit cycle. In the EU, the accounting framework became mandatory for listed banks from 2018. IFRS 9 was a fundamental reform of how credit losses are recognised, as banks will need to anticipate losses. If a loan is already classed as defaulted, the losses expected over the entire remaining lifetime will need to be set aside. This was intended to help converge provisioning levels between similar credit portfolios.

Ahead of the introduction of IFRS 9, regulators debated whether the new accounting practices could in fact lead to pro-cyclical lending behaviour. Given the need to anticipate losses, credit might contract once the macroeconomic outlook deteriorates drastically. However, for most observers such a dynamic seemed unlikely (Cohen and Edwards, 2017). By contrast, it was understood from the outset that the new system would allow considerably wider scope for judgement and discretion by bank managers when deciding on the migration of loans between stages of credit losses, potentially resulting in ‘cliff effects’ (Nowotny-Farkas, 2016).

In March 2020, European supervisors nevertheless quickly decided to pre-empt any adverse effects of the new accounting framework on credit-driven stabilisation. The still recent switch in regimes, and the effect of the abrupt change in the macroeconomic outlook for growth and credit risk, should not result in adverse effects on banks’ capital base. Amendments and clarifications affected three aspects of IFRS implementation:

- An inevitable consequence of the requirement to apply management judgement under IFRS 9 is that banks’ expected losses are driven by models and macroeconomic assumptions. This seems to explain the high variance in provisioning outcomes. In addition, disclosure practices varied greatly (S&P Global Ratings, 2021). Banks were therefore sensibly encouraged to take long-term scenarios into account. Macroeconomic uncertainty was at an all-time high, and ECB forecasts were suggested as a common basis as private-sector forecasts diverged widely.
- The original EU regulation that introduced IFRS 9 already allowed banks to take advantage of a lengthy transition phase. Under the regulation (EU 2016/2067), banks could add back to their CET1 capital the change resulting from the new regime, though this amount would gradually decrease<sup>20</sup>. The Commission, in its Communication in April 2020, announced that this transition would be extended by another two years. On this basis, the ECB encouraged banks to opt into such a transitional arrangement and suggested it would approve such requests speedily. This change in the regulation complemented other measures aimed at augmenting banks’ capital bases and lending headroom, though the added lending capacity from the extended IFRS 9 transitional phase would remain relatively minor (about 0.3 percentage points in a targeted additional capital headroom of 2.5 percent). Even though many banks decided not to use the

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<sup>20</sup> Banks were allowed to reduce the impact on CET1 capital by 70% in 2020, and this share would gradually fall to 25% in 2022.

transitional arrangement in 2018, most now do (EBA, 2018b). This is unlikely to undermine transparency of financial statements, as market analysts in any case normally assess banks' regulatory capital net of any transitional arrangements (on a 'fully-loaded' basis).

- The statements by the Commission, EBA and ECB also encouraged banks to apply judgement and flexibility in identifying exposures with a significant increase in credit risk ('SICR'). Under the IFRS 9 standard, such a determination for individual borrowers is the trigger for charging expected losses from the exposure on a lifetime basis for underperforming and non-performing defaulted exposures. This original interpretation by the Commission was consistent with the principles of the accounting framework, and with further clarifications offered by the accounting standards board at the time (IASB, 2020)<sup>21</sup>. It essentially sought to avert summary downgrades of portfolios due to the fact that payment moratoria were made available to all borrowers, not just those subject to a significant increase in credit risk. The Commission, for instance, emphasised that a punctual or temporary increase in the probability of default should not necessarily lead to a significant increase in the probability of default expected over the subsequent twelve months. The Commission, ECB and EBA also stated that the mere use of moratoria by borrowers whose loans had previously performed well should not be construed as triggering such an increase in credit risk.

The expansion in lending and easing of credit standards in mid-2020 suggests that these *ad-hoc* adjustments to provisioning requirements, together with other capital and refinancing measures, were successful in avoiding the feared procyclical credit tightening at the onset of the crisis.

Yet, the ECB has admitted that the initial flexibility has not given way to closer scrutiny of individual exposures by banks. Summarising the 2020 cycle of discussions with banks, the ECB suggests that nearly all banks have shown higher provisions in 2020 compared to the previous year, with the bulk of loan losses having occurred in the second quarter (when further disruption was yet to materialise). However, these were largely undifferentiated or so-called collective provisions. For a large number of ECB-supervised banks these increases in the costs of risks were not matched by the growth in individual exposures classified at higher risk ('stage 2')<sup>22</sup>. The share of exposures in the third stage of impaired loans has remained unchanged and does not differ markedly for loan portfolios subject to moratoria.

In aggregate terms, loan loss provisions for euro-area banks by Q3 2020 did not seem to match the extent of the economic disruption. There appeared to be variations between banks that could not be explained by underlying factors, such as composition of assets or depth of the local downturn (ECB, 2021). ECB-supervised banks seemed to have taken very different approaches to loan loss provisioning and, on the whole, bank-internal models have changed in a way to make the probability of default less sensitive to economic contraction (ECB, 2020).

The ECB has now publicly stated its concern that banks have not adequately prepared for the new risk environment by making borrower-level assessments. Credit risk has now become one of the priorities for the new cycle of supervision in 2021 (ECB, 2021). The December 2020 letter to CEOs urged supervised banks to step up efforts to identify, measure and manage borrower-specific risk, and most banks were given credit risk recommendations (directing banks to make additional provisions). In its priorities for the 2021 Supervisory Review and Evaluation Process (SREP) the ECB acknowledged that:

<sup>21</sup> To assess SICR IFRS 9 requires that banks assess changes in the risk of a default occurring over the expected life of a financial exposure. Both the assessment of SICRs and the measurement of ECLs are required to be based on reasonable and supportable information that is available without undue cost or effort.

<sup>22</sup> ECB (2021).

*“deteriorating economic conditions during the pandemic slowed the pace of the ongoing reduction in non-performing loans but there is also an embedded level of distress in loan books that is not yet fully evident. The phasing-out of several support measures in 2021 may increase the risk of cliff effects”<sup>23</sup>.*

Therefore, the initial support given to more flexible accounting treatment of pandemic-related losses has now been largely withdrawn. There is little to suggest the ECB actively contributed to what it now publicly flags as lax credit risk management among some banks. This seems to have been addressed through detailed guidance at least since December 2020. The deteriorated macroeconomic outlook and longer-lasting restrictions will need to be reflected in additional provisions. As not enough individual exposures have been moved into higher expected loss stages, banks may be poorly prepared to identify and handle more widespread defaults and to offer restructuring solutions to individual borrowers.

### 4.3. Tolerance of higher NPL levels

The euro area has made substantial progress in reducing non-performing loans. EBA figures underline a convergence in NPL levels not just between countries, but also between banks within individual countries (EBA, 2019).

A key factor in this apparent success has been the greater scrutiny applied by supervisors to banks' internal capacity and governance arrangements in managing distressed loans. Based on the ECB's NPL Guidance document (ECB, 2017), banks have been required to adopt distressed loan management strategies, set targets for the reduction of NPL stocks, and to back the strategy with sufficient internal staff and IT resources. On the basis of this, policy supervisors have been able to set time-bound targets for NPL reductions, which were in some cases detailed by asset type<sup>24</sup>. For banks, the so-called provisioning backstop in the CRR (EU 2019/630) combined with the Addendum to the ECB NPL Guidance provided an additional incentive.

The 2017 ECB Guidance defined options for the supervisory dialogue within the so-called Pillar II process. Application is at the discretion of supervisors and is differentiated depending on the bank's circumstances. There appears to be no public evaluation of how this instrument has been applied. Initially, the ECB emphasised that it would not be overly prescriptive in setting NPL reduction targets, and that targets would be based on dialogue with the banks. However, press reports and presentations by banks indicate that there was in fact significant pressure on high-NPL banks soon after the guidelines came into effect. About 30 banks with above-average NPL levels were in a priority group.

The greater scrutiny by ECB supervisors seems to have resulted in much more determined strategies for distressed loan resolution by high-NPL banks (Lehmann, 2018). This has complemented other prudential measures, in particular the provisioning backstop which forces time-bound write-downs of defaulted loans. Banks' loan documentation, collateral valuation processes and the management of loan restructuring has improved in line with the guidance. This is likely to have made more disposals of loan portfolios in secondary markets feasible, and possibly raised valuations for such portfolios. Similar targets for NPL reductions were first applied, with some success, in Ireland from around 2013 in

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<sup>23</sup> ECB press release, 28 January 2021: [“ECB asks banks to address credit risk and improve efficiency”](#).

<sup>24</sup> A similar document issued by the EBA in 2018 was the basis for other national supervisors issuing guidelines applying to the less significant institutions (EBA, 2018), and for an application by a national supervisor for instance see Bank of Italy: 'Guidance on the management of non-performing loans for Italy's 'less significant institutions', January 2018.

the aftermath of its property market crisis (Donnery *et al*, 2018)<sup>25</sup>. This experience underlined that once bank managers are held accountable for certain limits of defaulted loans, and for a time-bound reduction towards such levels, they raise standards in internal workout processes and make a greater share of distressed loans suitable for disposal to investors.

The statements made by the ECB at the onset of the crisis suggest this relatively successful policy of setting bank-specific targets has now been scaled back. ECB statements, such as that cited above, suggested that previously-agreed limits for NPLs in individual banks, and paths for reductions towards such limits, became more flexible in 2020. It is not clear whether this also implies a greater tolerance of renewed increases in NPLs in other banks.

The evolution of NPL levels following the pandemic will be determined by a range of factors, including the pace of the economic recovery and the re-opening of certain services businesses that depend on regular and direct customer interactions. Insolvency laws in some member states have been reformed based on the Restructuring Directive (EU 2019/1023), and will make the pre-insolvency rescue of viable businesses more likely, easing pressure on NPL formation. The Commission has started a process that will further widen options for NPL disposals in secondary loan markets (European Commission, 2020). This more fully fledged strategy, together with the sounder prudential position of euro-area banks, is likely to result in a more rapid workout process than was observed in the previous crisis, when the euro-area NPL ratio rose over a period of about four years to a peak in 2015 at 7 percent (EBA, 2019).

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<sup>25</sup> From 2013, the Central Bank of Ireland imposed so-called mortgage arrears reduction targets which were quarterly quantitative targets applying to the six main mortgage lenders (accounting for approximately 90 per cent of the Irish mortgage market), applying to both primary residences and buy-to-let mortgage portfolios.

## 5. CONCLUSIONS

The euro-area banking system played a crucial role in stabilising economies at the onset of pandemic-related lockdowns in 2020. Payment moratoria and public guarantee schemes were offered in most member states and were a key factor in this credit recovery. National measures in turn depended on support provided by EU regulation and ECB supervision. A number of interpretations and press statements by the Commission, EBA and ECB signalled a flexible approach at the start of the crisis, though did not represent fundamental changes in the underlying standards for loan quality definitions and accounting rules.

These supportive policies are now set to expire. The EBA Guidelines on the exemption of moratoria loans from forbearance classifications runs until the end of March. Even though lockdown restrictions for businesses have been further extended into 2021, prolonging national moratoria schemes with the associated blanket treatment of borrowers does not make sense. The granting of publicly-guaranteed credit has also levelled off, though the Temporary Framework for state aid, which underpinned all schemes, runs until end-2021. The ECB has already signalled much closer scrutiny of banks' credit risk management, ending what banks may have wrongly perceived as earlier tolerance of poor practice in this area. Relief from various other projects in supervision, such as the review of banks' internal risk models, is also coming to an end.

The ECB and EBA will need to address any perception among market participants that flexibility shown during the crisis implies that supervisors would continue to tolerate delayed recognition of loan losses and of non-performing assets. At the same time, the withdrawal of these supportive measures, and the end of moratoria themselves, will need to be well managed to avoid the 'cliff-edge' risks of an abrupt policy change.

The first priority is to enforce accurate reporting of defaults and other non-performing loans as national moratoria expire, enforcing banks' existing obligations under the EBA Guidelines. Transparent and credible loan quality reporting has been a major success of regulatory reform since the 2008-12 financial crisis. Accurate default data and disclosure of such figures in the market are preconditions for sound supervision and macroprudential policy; suspending the need for borrower-level default assessment, or weakening the definition of what constitutes a distressed restructuring, would undermine this standard. The EBA Guidelines, together with separate reporting and disclosure requirements, provide some safeguards, though banks do not seem to have undertaken the borrower-level scrutiny that was expected. Enforcement is now primarily a task for ECB supervision.

A second more long-term agenda should address the implementation of IFRS 9. Europe's new accounting framework needs to become more consistent and predictable. The extension of the transitional arrangement, the lack of comparability between the approaches and projections used by major banks, and banks' slow re-rating of exposures into higher risk stages, underline that the new accounting framework suffered a setback in the crisis. The ECB's new focus on credit risk management practices is likely to address such a consistent application of accounting rules. In addition, the supervisor could also focus on closing disclosure gaps and raising the consistency of disclosures by institutions. This would be in line with the recommendations of the Enhanced Disclosure Task Force sponsored by the Financial Stability Board (2015).

Lastly, flexibility in the ECB's policy on banks' NPL reduction strategies is sensible even though schedules for minimum provisioning should remain unchanged. A dispersion in NPL levels will inevitably emerge as countries and banks are exposed to vulnerable sectors and business models to varying extents. New NPLs will arise among corporate and SME loans that have only a recent history of arrears and are as yet outside foreclosure or insolvency enforcement. This is a crucial difference



compared to the much more dated non-performing loans which emerged in the previous crisis, and which were more fully provisioned and collateralised with real-estate assets. Private investors and loan servicers in secondary loan markets may not have sufficient capacity, expertise and financing options to take on such assets in large volumes.

Banks' NPL reduction strategies need to reflect the need for wide-ranging debt restructuring of companies that emerge from the crisis over-leveraged but still viable. Flexibility exercised vis-à-vis individual banks also seems to be justified from the perspective of macroprudential policy. Forcing an overly rapid NPL resolution process and disposals could result in fire-sale valuations of collateral in illiquid asset markets. Also, secondary loan markets are still beset by informational asymmetry and other market imperfections, constraining the ability of banks to achieve valuations close to real economic values (ESRB, 2017). An undifferentiated strategy of disposing of NPLs in loan markets may not be adequate, given the need for complex debt restructuring, in particular for SMEs.

In a debate about these issues the following questions could be considered:

- How will the ECB assess banks' readiness and operational capacity to deal with distressed borrowers, and how will its findings be communicated to the market?
- The ECB has acknowledged a concern about the relative lack of idiosyncratic increases in credit risk. How will the ECB evaluate its policy on banks' credit risk management, which was announced in December 2020?
- How can the ECB assure a wider and more consistent application of its NPL guidelines, and also create transparency about banks' expectations, adjustment paths and preferred workout options, reconciling macroprudential objectives, with requirements for individual banks? Could the requirement to document bank-specific strategies to deal with non-performing loans be applied to all banks under direct ECB supervision?<sup>26</sup>

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<sup>26</sup> Currently, only those deemed to be 'high-NPL' banks are required to submit such plans by March 2021.

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This paper examines regulatory measures and supervisory practices that have supported public guarantee schemes and moratoria in euro-area countries. The focus is on flexibility shown with regard to default classifications, accounting practices and the treatment of non-performing loans. The paper identifies a number of undesirable effects and examines how soon such policies can be normalised.

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