EUROPEAN CENTRAL BANK

BANKING SUPERVISION

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Chair of the Supervisory Board

To the CEO of the significant institution

SSM-2020-0744

Frankfurt am Main, 4 December 2020

Identification and measurement of credit risk in the context of the coronavirus (COVID-19) pandemic

Dear Sir/Madam,

Following the deliberations of the Supervisory Board, the purpose of this letter is to provide banks with additional guidance on credit risk identification and measurement in the context of the coronavirus (COVID-19) pandemic. In this regard, the ECB issued a letter on 1 April 2020[1] which clarified that while significant institutions should apply the flexibility available under existing accounting standards to absorb the impact of credit risk developments and to mitigate excessive pro-cyclicality, they should continue identifying and reporting asset quality deterioration and the build-up of NPLs in accordance with the existing rules, so as to maintain a clear and accurate picture of risks in the banking sector. At the same time, the ECB reminds that the capital relief measures adopted since the early stages of the pandemic are aimed at allowing banks to cushion these credit risk developments while continuing to ensure a smooth financing of the economy.

As the COVID-19 pandemic has progressed, the ECB's supervisory activities have identified heterogeneous practices among significant institutions in implementing the 1 April 2020 letter. Therefore, as elaborated in this follow up letter, and consistently with the ECB's previous communications on provisioning practices in the context of the COVID-19 pandemic, it is becoming increasingly important for significant institutions to ensure that risk is adequately assessed, classified and measured on their balance sheets. This serves to provide appropriate solutions to distressed debtors in a timely manner, helping to contain the build-up of problem assets at banks thus minimising and mitigating any cliff effects where possible. In this regard, it is crucial that significant institutions strike the right balance between avoiding excessive pro-cyclicality and ensuring that the risks they are facing (or will face) are adequately reflected in their internal risk measurement and management processes, financial statements and regulatory reporting.

Significant institutions should use well-structured and sound creditworthiness assessment procedures so they can differentiate, in a timely and effective manner and on a case-by-case basis where appropriate, viable from non-viable debtors. This process should also take into account the expiry of public support

1 See the ECB's letter entitled "IFRS 9 in the context of the coronavirus (COVID-19) pandemic" and FAQs on ECB supervisory measures in reaction to the coronavirus

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measures currently in place. Furthermore, from a prudential perspective, in order to properly manage and cover credit risk, it is important for Significant Institutions to allocate exposures to the appropriate IFRS 9 stages and use all relevant information to determine expected credit losses.

The ECB therefore expects significant institutions to pay particular attention to what the ECB considers to be sound credit risk management policies and procedures, as set out below. Further detail is provided in Annex 1.

First, significant institutions should ensure that they have enhanced their procedures so that all contract modifications that qualify as concessions and are provided to distressed borrowers, in line with Article 47b of Regulation (EU) No 575/2013 (the Capital Requirements Regulation, CRR)[2], are correctly classified as "forborne" in their systems. For credit facilities subject to modifications that do not meet the criteria for general payment moratoria laid down in the EBA guidelines on payment moratoria,[3] significant institutions should assess and classify accordingly, on a case-by-case basis, if the modifications satisfy the definition of concession and meet the financial difficulties criteria.

Second, significant institutions are expected to perform a regular assessment of borrowers' unlikeliness to pay, including exposures with general payment moratoria, using all relevant and available information; when the assessments are performed manually, banks are expected to follow a risk-based approach. Significant institutions should ensure they have enhanced their existing processes, indicators and triggers so that they are appropriate for the current risk environment. Similarly, significant institutions should also ensure their early warning systems are effective.

Third, from a risk management perspective and in order to set appropriate provisions for prudential purposes, the ECB is of the view that significant institutions should identify and record any significant increase in credit risk at an early stage. Significant institutions should not rely solely on days past due as a trigger for a significant increase in credit risk[4]. In addition, practices such as setting targeted amounts of stage transfers or using reverse engineering to achieve targets should not be used.

Fourth, from a prudential perspective, to ensure the sound measurement, management and coverage of credit risk, the ECB considers it essential that significant institutions correctly estimate their provisions using realistic parameters and assumptions which are appropriate for the current environment. In this regard, significant institutions are recommended to continue anchoring their IFRS 9 baseline scenarios using the ECB's forecasts in an unbiased manner. At the same time, significant institutions should not rely solely on through-the-cycle approaches or long-term averages but should instead consider incorporating reliable macroeconomic forecasts (if these are available) for specific years. Significant institutions should ensure that overlays are directionally consistent with macroeconomic scenarios based on verifiable evidence.

2 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms (OJ L 176, 27.6.2013, p. 1).

3 See EBA/GL/2020/02, "Guidelines on legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis".

4 According to IFRS 9 5.5.11: "If reasonable and supportable forward-looking information is available without undue cost or effort, an entity cannot rely solely on past due information when determining whether credit risk has increased significantly since initial recognition […]".

Fifth, the ECB expects the management bodies of significant institutions to exercise adequate oversight over the critical elements of credit risk management. In addition, significant institutions should also ensure there is segregation of duties across loan origination, risk monitoring and the collection and restructuring processes, as well as adequate internal and external reporting of the relief measures. In addition, the internal audit and internal control functions are expected to perform adequate assessment and monitoring activities in respect of the processes which have been amended in the wake of the pandemic.

Finally, as a part of strategic and business planning, the ECB expects significant institutions to forecast the most likely impact of the crisis in terms of stage allocations, provisioning and capital.

Significant institutions should bear in mind that the contents of this letter are a reminder of existing regulations and guidelines and are therefore expected to be incorporated into the current year's regulatory reporting, as well as future budgetary and strategic planning. The ECB intends to use a wide range of supervisory tools to actively follow up on all aspects of this letter.

We encourage your institution's management body, in its supervisory function, to discuss the contents of this letter. The Joint Supervisory Team would appreciate a response to this letter, approved by the management body in its supervisory function, by 31 January 2021. Guidance on the expected response is included in Annex 2. The ECB will assess the replies provided by Significant Institutions and engage with them to understand their practices on the different aspects mentioned in this letter with a view to assessing on a case-by-case basis if supervisory measures under Article 16(2)(d) of Council Regulation (EU) No 1024/2013[5] are necessary in case the arrangements, strategies, processes and mechanisms implemented do not ensure a sound management and coverage of incurred credit risk.

Yours sincerely,

[Signed]

Andrea Enria

5 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L 287, 29.10.2013, p. 63–89.

Annex 1

This annex provides significant institutions with more details of the ECB's observations on the specific issues and clarifies what the ECB considers to be prudentially sound practices in the identification, classification and measurement of credit risk. This communication is consistent with and further complements the letter on IFRS 9 in the context of the coronavirus (COVID-19) and ECB Letter on Operational capacity to deal with distressed debtors in the context of the coronavirus (COVID-19) pandemic and provides further clarifications in the areas where heterogeneous practices have been observed in the ECB's supervisory activity. In this regard, the term "classification and measurement" is used in the broader context of risk management rather than solely for accounting purposes. This annex aims to provide significant institutions with a non-exhaustive indication of sound policies and procedures in this area.

The ECB will assess significant institutions' credit risk management policies and procedures on a case-by-case basis, taking individual circumstances into consideration.

With regard to the coverage of credit risk from a prudential perspective, the ECB has decided to provide further clarification to significant institutions by specifying the provisioning practices that the ECB considers to be sound from a prudential perspective. These clarifications are consistent with the expectations that the ECB has previously communicated and with the statements issued by other EU authorities and international bodies with regard to the use of IFRS 9 in the context of the COVID-19 outbreak, including the European Banking Authority (EBA), the European Securities Markets Authority (ESMA) and the International Accounting Standards Board (IASB). This letter is consistent with the EBA guidelines on accounting for expected credit losses.[6]

Issue	Sound policies and practices
Projections of the likely impact of COVID-19 on capital and asset quality • **Quantification of the likely impact of COVID-19 is still a work-in-progress for many significant institutions.** Significant institutions should make further efforts to ensure that projections are reliable and that all relevant parameters (e.g. non-performing exposures) are available.	**The ability to quantify the likely impact of COVID-19 is crucial for proper strategic and business planning. It is essential in order to prepare for an expected increase in the number of distressed debtors and to properly address this.** • The risk and finance functions of significant institutions **forecast the most likely impact of COVID-19** in terms of exposure classification, provisioning and capital impact, following the migration of debtors across stages and adapting rating systems, risk parameters and assumptions to the COVID-19 measures (grace periods, mitigation effects, uneven impacts related to vulnerable sectors, among others). • Given the level of uncertainty, the risk and finance functions assess the above impact **using various scenarios**.
Identification and classification of	**Robust processes for the identification and classification of**

6 See EBA/GL/2017/06, "EBA Guidelines on credit institutions' credit risk management practices and accounting for expected credit losses."

forbearance
 	
• The ECB has observed that modifications of terms and conditions that do not meet the criteria of the EBA guidelines on payment moratoria, and that would qualify as **forbearance** measures, are granted but may **not always be classified correctly**
• In some cases, these observations relate to deficiencies in forbearance flagging already communicated before the outbreak of COVID-19.
• However, in other cases it is related to a relaxation of the criteria for forbearance flagging, such as the exclusion of temporary difficulties.
• This makes it more difficult to ensure that the most appropriate solutions are provided to viable borrowers in a timely manner while also protecting significant institutions against negative credit risk effects.
	forbearance are necessary for the adequate monitoring and timely management of these exposures. The current COVID-19 situation calls for an enhancement of these processes.
	
	• Significant institutions **enhance their processes and controls in order to detect any early signs of financial difficulty. This is to ensure that processes and controls are in place that are effective in the current environment,** and also that appropriate support measures can be provided to viable distressed borrowers.
	    • In this regard, an assessment of financial difficulties is conducted for exposures for which the borrower does not appear to be in financial difficulties, but where market conditions have changed significantly in a way that could impact upon the borrower's ability to repay. The resulting assessment of each borrower's financial difficulties is accurately reflected in prudential and accounting classification.
	• As set out in the **EBA guidelines on payment moratoria**[7], modifications which meet the criteria for **general payment moratoria** do not have to be reclassified as forborne. However, the ECB would like to remind significant institutions, as stipulated in paragraph 19 of the aforementioned EBA guidelines, that **loans which have been granted general payment moratoria, or any other modification to terms and conditions, should be clearly identifiable, collectable, and readily accessible in their IT systems, so that they can be adequately traced and monitored**.
	• Regarding the **identification of forbearance for modifications that do not meet the criteria for general payment moratoria** laid down in the EBA guidelines on payment moratoria, significant institutions continue to assess modifications to the terms and conditions of credit facilities on a case-by-case basis and classify these modifications according to the current regulatory framework for forbearance[8] and report them in accordance with Regulation (EU) No 680/2014.
	• For the avoidance of doubt, **for exposures that do not meet the criteria for general payment moratoria, when granting concessions significant institutions should assess** the items below.
	    o Whether the modification of the terms and conditions or the refinancing meets the definition of concession according to Article 47b(1) of the CRR.
	    o Whether the borrower is experiencing, or is likely to experience, financial difficulties (even if only temporarily) in repaying the loans which should be flagged, accordingly, as forborne. This applies at least (but not only) to the

7 See EBA/GL/2020/02, "Guidelines on legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis".

8 In accordance with Article 47b of Regulation (EU) No 575/2013, and whether they are treated as distressed restructuring in accordance with Article 178(3)(d) of Regulation (EU) No 575/2013 and Commission Implementing Regulation (EU) No 680/2014 of 16 April 2014 laying down implementing technical standards with regard to supervisory reporting of institutions.

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situations covered by Article 47b (2) of the CRR.
Whether the concession constitutes distressed restructuring according to Article 178.3(d) of the CRR and should therefore be classified as a non-performing exposure.
For example, for households, employment in a heavily impacted sector and non-availability or only limited availability of any other source of income could indicate financial difficulties, while for non-financial companies operating in an impacted sector or limited availability of liquidity/ financial buffers could indicate financial difficulties.
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Assessment of unlikeliness to pay

Significant institutions generally perform an unlikeliness-to-pay assessment (although mainly using unchanged processes and indicators).
However, typical behavioural indicators do not work for exposures with moratoria and not all information is currently available.
Some inadequate practices have been observed (e.g. “wait and see” assessments which are performed but are not followed by any reclassifications).
Some significant institutions have already started to enhance their approaches (e.g. by developing new indicators, using alternative sources of information, and leveraging on high risk/vulnerable sector analysis).

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Significant institutions should assess borrowers’ unlikeliness to pay[9]. The challenges posed by the absence of payment data and the lack of representativeness of financial information call for the enhancement of existing processes, indicators and triggers. Among other things, significant institutions should take the action below.

Prioritise the manual assessment of obligors who have been materially impacted by the pandemic (e.g. by performing a sectoral and risk segmentation identifying the most vulnerable sectors and sub-sectors). Adopt a consistent and robust approach to assess each sector’s outlook, feeding this into individual borrower credit assessments.
Use, in a structured and traceable manner, up-to-date sources of information and enhanced methodologies when assessing the financial position of borrowers.
Have in place a comprehensive client outreach programme (based on the sectoral and risk segmentation) to collect the most up-to-date (financial) information on the current and expected financial position of non-financial corporations . Assess additional support obtained by the borrower from public authorities.
For household exposures approaches to identifying early signs of financial distress (e.g. transactional account data) could be explored. If relevant for UTP identification, up-to-date information on employment status, sector of employment and access to and usage of any public authority support schemes could be obtained.
Conduct more frequent reviews for higher-risk borrowers (e.g. customers on a watch list or who have a weak rating). These reviews continuously challenge the long-term viability of the debtors or the debtors’ capacity to repay debt and are reflected in the corresponding regulatory reporting.

In respect of the assessment of unlikeliness to pay in the case of borrowers subject to general payment moratoria, the ECB would like to remind significant institutions that, in line with the EBA guidelines on payment moratoria, banks should carry out unlikeliness-to-pay
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9 Any form of credit risk mitigation, such as guarantees provided by third parties to institutions, should not exempt institutions from assessing the potential unlikeliness to pay of the obligor, or affect the results of such an assessment.

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<td>assessments during moratoria. Once a moratorium has expired, significant institutions prioritise the assessment of obligors who immediately experience payment delays or where any concessions are granted shortly after the end of the moratorium.</td>
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<td>Staging and provisioning

The ECB has observed a diverse range of provisioning practices, some of which might lead to inadequate credit risk coverage and might hinder the accurate assessment of the underlying credit quality of exposures. These include:
“wait and see” approaches followed in situations in which delinquency-based triggers are not working;
approaches involving the modification of triggers and thresholds (e.g. an increase in probability of default (PD) thresholds);
biased approaches used when macroeconomic forecasts are incorporated.
The ECB has also observed that some sounder practices are being used to determine approaches to transfers to stage 2 for those cases in which individual assessments are not possible or the usual indicators do not work. Practices include top-down/bottom-up assessments, the analysis of vulnerable sectors, and the use of alternative indicators.</td>
<td>From a prudential perspective, sound staging and provisioning policies and procedures are key to ensure adequate credit risk management and coverage, including the timely identification and management of distressed debtors.

Macroeconomic forecasts for the purposes of IFRS 9
In its letter “IFRS 9 in the context of the coronavirus (COVID-19) pandemic” dated 1 April 2020[10], the ECB recommended that, for prudential purposes, significant institutions anchor their forecasts in regularly published ECB macroeconomic projections. However, when forecasts for specific years lose reliability, banks use long-term macroeconomic forecasts evidenced by historical information.
These recommendations may be viewed as guidance for what the ECB considers to be the sound implementation of accounting policies from a prudential perspective and are not to be misunderstood as the relaxation of any existing accounting requirements. Therefore, and consistent with the letter dated 1 April 2020, while significant institutions should continue anchoring their IFRS 9 baseline scenarios to the ECB’s forecasts in an unbiased manner, where reliable macroeconomic forecasts for specific years are available significant institutions should take them into account avoiding the sole use of long term averages.[11] This serves to minimise and mitigate, where possible, any cliff effects while, as recommended in the ECB’s letter of 1 April 2020, also limiting excessive pro-cyclicality. However, it is crucial for significant institutions to strike the right balance between avoiding excessive pro-cyclicality while ensuring that the risk they are facing, or will face, is adequately reflected in their regulatory reporting.
Significant Institutions also avoid using biased approaches which artificially stabilise provisions. Significant institutions consider achieving a balanced distribution of alternative scenarios around the baseline scenario anchored in the ECB forecasts.</td>
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10 According to the guidance contained in this letter, banks should “assign more weight to the specific-period macroeconomic forecast for the short-term outlook and systematically reduce that weight as the forecast loses relevance for time horizons in the more distant future” and should “use the long-term forecast (e.g. the long-term GDP growth rate) whenever the specific forecast has lost relevance”. The guidance also states that “given that published ECB staff macroeconomic projections for the euro area only cover the current and the next two calendar years, and also that the published ranges of uncertainty expand considerably along these years, the ECB is of the opinion that, irrespective of the current crisis, institutions should only use the long-term forecasts beyond the horizon of those projections”.

11 According to IFRS 9.BC5.282: “[…] through-the-cycle approaches […] result in a loss allowance that does not reflect the economic characteristics […] at the reporting date.”

	• The above considerations are also taken into account to determine stage 3 provisions. ***Assessment of significant increases in credit risk*** • **A significant increase in credit risk is identified at the earliest possible stage, whether using individual or collective assessments**, to ensure that there are adequate levels of provisions for prudential purposes. The fact that moratoria do not automatically trigger a reclassification of exposures does not mean that the duty to assess whether asset deterioration has taken place can be neglected. • It is recalled that, for **loans subject to moratoria**, the complementary stage 2 and 3 **transfer triggers** required by IFRS 9.B5.5.1 to IFRS 9.B5.5.18 and Appendix A **are assessed more comprehensively.** This is because delinquency-based triggers have been somewhat compromised for those exposures given that days past due are counted only based on the revised schedule of payments (EBA/GL/2020/02, para 13).[12] • **Forbearance measures which are not compliant with the EBA guidelines on payment moratoria generally constitute an indicator fora transfer to stage 2** (or credit impaired) **unless** the significant institution assesses, usually by means of a client-specific assessment and on the basis of other indicators, that credit quality has not deteriorated significantly. • Significant institutions take IFRS 9.5.5.11 into consideration. **All exposures that are more than 30 days past due are considered to have suffered a significant increase in credit risk** unless the institution rebuts this assumption on a case-by-case basis, citing reliable evidence. • It is recalled that, in addition to statistical data, IFRS 9.B5.18 requires banks to **use qualitative information to determine which exposures require lifetime expected losses to be recognised**. The information used for this purpose is aligned with the risk indicators used in client and portfolio monitoring and also includes items such as forbearance, increased indebtedness, repayment unsustainability, and breach of lending policies. • **Smoothing stage transfers** performed by setting targeted amounts or using reverse engineering to achieve those targets (e.g. by defining ex ante a desired quantile of the loan book that should be allocated in stage 2 in the long run or by adjusting stage transfer thresholds based on predefined quantiles) **is avoided** for prudent risk management reasons, to ensure an adequate level of provisions. • It is recalled that **stage transfer triggers defined in absolute terms** (either as an absolute PD level or an absolute PD

12 See also "Statement on the application of the prudential framework regarding Default, Forbearance and IFRS 9 in light of COVID19 measures", EBA, 25 March 2020, p. 4.

	increase) **are not generally considered to be in line with IFRS**.[13] • In addition, **internal thresholds used to determine a significant increase in credit risk follow the best practices that have been established since the introduction of IFRS 9** and are not relaxed when the credit quality of the portfolio deteriorates or becomes more volatile.[14] • **Thresholds are also consistent across portfolios and do not systematically favour riskier borrowers** (e.g. by implementing higher relative stage transfer thresholds which are applied to debtors with generally higher PDs, worse ratings at origination or more volatile rating migrations[15]). In this regard, and also in line with the AQR Manual[16] and the EBA Stress Test Methodological guidance[17], significant institutions consider, the appropriateness of a threefold increase in the (annualised) lifetime PD from initial recognition as a backstop measure for a significant increase in credit risk. These levels are consistent with what the ECB has observed in recent quantitative surveys across participating significant institutions which were carried out before the onset of the pandemic. To ensure that there is a sufficient level of provisions, this well-established threshold has, therefore, not been relaxed during the COVID-19 pandemic. ***Use of overlays in the application of IFRS 9*** • It may be necessary to use subjective model inputs and post-core model adjustments (overlays), given the current level of uncertainties. However, **subjective inputs are directionally consistent with objective and verifiable evidence such as observable macroeconomic variables and forward-looking forecasts**. Overlays are supported by adequately documented processes and subject to strict governance oversight – this ensures that documented processes are followed consistently over time and across exposures.[18] • Borrowers are being affected (directly or indirectly) by the coronavirus (COVID-19) pandemic to a different extent, depending on their sector. In this regard, **macroeconomic**

13 According to IFRS 9.B5.5.9, when determining the significance of an increase in the credit risk, "a given change, in absolute terms […] will be more significant for a financial instrument with a lower initial risk […] compared to a financial instrument with a higher initial risk […]". Unless all instruments to which an absolute trigger is applied share the same initial risk or the instruments still benefit from the low credit risk exemption, an absolute increase in PD is not suitable to determine the significance.

14 According to IFRS 9.5.5.9, the assessment of a significant increase in credit risk should be based on reasonable and supportable information which is available without undue cost and effort. As far as reasonable and supportable information results from an internal PD-model, the threshold at which this model can discern a significant increase in PD needs to be considered consistently over the time the model is used. Model changes that alter this threshold are subject to adequate model governance and validation processes. This also applies to external ratings used as reasonable and supportable information, i.e. the threshold at which external ratings can discern a significant increase needs to be considered consistently.

15 Paragraphs 2.12 to 2.15 of the IFRS Framework require financial information to be neutral and free from bias.

16 Banking Supervision: Asset Quality Review – Phase 2 Manual, ECB, June 2018.

17 2020 EU-Wide Stress Test: Methodological Note, EBA, November 2019.

18 See paragraph 33(f) of EBA/GL/2017/06.

	information and/or the adverse business impact on specific sectors might in itself indicate that there has been a significant increase in credit risk for adversely affected exposures.[19] A transfer to stage 2 may be necessary solely because of these particular circumstances, unless more granular information is available to show that exposures may still remain in stage 1. Using a more differentiated approach, it may be possible to rebut the assumption that adverse effects stemming from the business, financial and economic environment affect the entire portfolio. • **If it is not possible to conduct a credit assessment of an individual client** because of a lack of current client-specific information, **significant institutions use the top-down and the bottom-up approaches** required by IFRS 9 (specifically paragraphs B5.5.6 and IE38 and IE39). To apply the top-down approach, significant institutions use a representative sampling approach to assess credit deteriorations. The results are then used to estimate the proportion of a portfolio that needs to be provisioned with lifetime expected losses. An alternative solution could be to rely on analytical approaches to systematically determine which portions of a portfolio have not experienced a significant increase in credit risk (e.g. by using representative migration tables if individual ratings are not available, since representative migration tables should be conditioned on the state of the economy). • **Management overrides of established quantitative approaches are generally avoided** – they are only applied at the most granular level possible and are **subject to robust governance and validation procedures**. More generally, an override only affects minor portions of the banking book for a limited period of time – it is based on a clear rationale supported by evidence.
The rating assignment process and risk parameter quantification In some cases the ECB has observed that the material deterioration of the economic environment has not been sufficiently taken into account in risk parameter quantification.	**Risk parameters are adequately assessed in order to accurately reflect increased credit risk in the capital positions of significant institutions.** Significant institutions consider the effects of COVID-19 and related mitigating measures (i.e. state guarantees and payment moratoria) in their rating assignment process and risk parameter quantification, in accordance with the current regulatory requirements and their approved models and processes and respecting the requirements of Delegated Regulation (EU) 529/2014 .

19 Evidence collected by the ECB on participating significant institutions' models shows, on average, that a 3% decline in GDP results in a threefold increase in PD. In addition, some industries are suffering from an obvious adverse change to their business environment. IFRS 9.B5.5.17(f) and IFRS 9.B5.5.17 (i) require a significant institution to consider all adverse changes to the business, financial and economic environment of the borrower.

	• **Any change** (e.g. "freezing" or "excluding" any component or variable of the PD model, a lower frequency of re-rating etc.) **would trigger the need for institutions to assess the materiality of the model change** and notify/request permission from the competent authorities accordingly.[20] • Consistent with the material deterioration of the economic environment, the granting of payment moratoria (whether compliant or non-compliant with the EBA guidelines) **does not generally lead to improvements in the risk driver values** compared to those observed before COVID-19. • For **moratoria that are not EBA compliant,** significant institutions reflect the restructuring event in the grade assignment, adopting a conservative approach if the model does not explicitly capture it. • If patterns materialise which show higher levels than those underlying current downturn estimates, a potential upwards revision of the loss-given-default and credit-conversion-factor estimates offers the benefit of facilitating proper risk management. It allows timely recognition of the effects of the coronavirus (COVID-19) pandemic and eliminates any need for a "huge upwards revision" at a later stage.
Collateral valuations **The up-to-date and well-documented determination of collateral valuations** is necessary to assess the quality of loans and the adequacy of provisions.	In line with the ECB Guidance to banks on non-performing loans, **significant institutions monitor individual collateral valuations for all exposures on a frequent basis.** This should take place at least once a year for commercial immovable property and at least once every three years for residential immoveable property**. Valuations should be updated where necessary.** • The valuation of immovable property collateral is updated on an individual basis at the time the loan is classified as a non-performing exposure, and at least once a year while it continues to be classified as such. • More frequent valuations are carried out if the market has been subject to significant negative changes and/or if there have been signs of a significant decline in the value of the individual collateral.
Governance and the involvement of management bodies **In some cases the ECB has observed:** • **insufficient involvement** of the management bodies in the oversight and management of the	**Adequate governance and the involvement of management bodies[21] are of the utmost importance in ensuring there is an adequate response to the challenges presented by the coronavirus (COVID-19) pandemic.** • The management bodies **perform adequate oversight of the critical elements of the management of credit risk, including the following:** o reviewing the significant institutions' credit underwriting

20 As within the scope of Commission Delegated Regulation (EU) No 529/2014.
21 For the avoidance of doubt, management bodies refer to both the executive and the supervisory functions.

response to COVID-19; • deficiencies in **data aggregation** and **data quality issues** in COVID-19 reporting; • insufficient involvement of the internal audit and internal control functions.	standards, risk appetite framework and strategy under realistic macroeconomic scenarios; ○ material changes to prudential and accounting frameworks; ○ ensuring that the taskforces set up to tackle the impact of the COVID-19 crisis have been appropriately mandated. • To ensure **a disciplined and effective segregation of duties across the loan origination, risk monitoring and collection and restructuring processes,** in a context in which the need for a prompt reaction to the coronavirus (COVID-19) pandemic might create an incentive to commingle activities normally allocated to separate functions and roles in the first and second lines of defence.[22] • The **internal audit and internal control functions adequately assess and monitor processes with regard to the risk from COVID-19** and the resulting risk measurement, ensuring that the relevant supervisory framework has been correctly interpreted. • The **internal and external reporting on the relief measures** are in line with EBA guidelines for payment moratoria and supervisory requirements, so significant institutions can aggregate it at consolidated level.

Annex 2

In their response, significant institutions should provide a sufficient level of qualitative and quantitative detail to enable the Joint Supervisory Team to understand the bank's approach on how they intent to address the gaps they have identified towards the clarifications included in each of the sub-paragraphs outlined in Annex 1. If any information has already been submitted either to the EBA or to the ECB, please do not submit it again. It is sufficient to refer to it. Please structure your response in accordance with the outline below.

1. General comments
2. Classification (forbearance and unlikeliness-to-pay assessment)
3. Staging and provisioning according to IFRS 9
4. Financial forecast to be used in risk management
5. Collateral valuations
6. Rating assessment process and risk parameter quantification
7. Governance and involvement of the management bodies

22 In accordance with the ECB Guidance to banks on non-performing loans, the ECB expects the workout units to be operationally independent from the units responsible for loan origination and classification.