To the CEO of the Significant Institution

Frankfurt am Main, 28 July 2020

Operational capacity to deal with distressed debtors in the context of the coronavirus (COVID-19) pandemic

Dear Sir or Madam,

The COVID-19 pandemic has disrupted European economies, increasing the vulnerability of the financial system. Supervisors, regulators and governments have reacted swiftly to limit the pro-cyclical impact of this crisis and ensure banks have access to additional resources that should be used to provide more financial support to borrowers. This letter aims to clarify ECB Banking Supervision’s operational expectations on the management of the quality of loan portfolios so that Significant Institutions can better provide this financial support to viable businesses that have or may come under distress as a result of the pandemic.

To be operationally effective in dealing with the credit risk emanating from this economic shock, the ECB Banking Supervision expects that Significant Institutions will follow the below supervisory expectations.

First, when supporting viable distressed businesses, Significant Institutions should provide sustainable solutions or support in an efficient and timely manner. This requires Significant Institutions to have in place effective risk management practices to identify, assess and implement solutions which can best support these businesses while protecting banks against any negative credit risk effects.

Second, Significant Institutions should take timely action to minimise any cliff effects when the moratoria measures begin to expire. As part of the response to the pandemic, large numbers of borrowers were granted short-term flexibility through a variety of measures that mainly suspended or deferred payments. It is crucial that Significant Institutions proactively identify and engage with potentially distressed borrowers ahead of the expiry of these measures in order to avoid large negative impacts on banks’ loan portfolios.

Third, Significant Institutions should have a clear understanding of the risks they are facing and devise an appropriate strategy, with both a short and medium-term focus, to ensure that the solutions provided to distressed viable debtors are sustainable. This strategy should also ensure that early arrears are managed in a timely manner, thereby contributing positively to the economic value of the underlying businesses and limiting the impact on banks’ balance sheets and the wider economy.

In practical terms, these supervisory expectations can be translated into a number of more specific operational elements which ECB Banking Supervision will assess through its process of ongoing engagement with Significant Institutions.

- **IT resources**: Significant Institutions are expected to have appropriate IT resources and systems to manage risk. At a basic level, they must be able to easily identify borrowers whose financial soundness has been affected by the COVID-19 pandemic and those who have been granted various public and private support measures. IT systems should therefore be adapted to enable banks to efficiently and comprehensively identify, assess and monitor the risks intrinsic to this crisis. IT systems should also allow for the swift and reliable aggregation of loans and portfolios according to the most relevant risk and business criteria.

- **Reporting**: Significant Institutions are expected to establish reporting lines to the management body with a comprehensive risk reporting package that covers all material risks, risk management policies and any changes thereof. This reporting should be sufficiently granular, provide early warning indicators which detect increases in risk at an early stage and also provide projections of how this risk will affect the bank in the short and medium term. A strong reporting package and an adequate early warning system will help management make critical strategic decisions on the basis of more detailed and accurate information. The reporting package should be updated regularly.

- **Segmentation**: Granular portfolio segmentation enables banks to group together borrowers with similar characteristics who require similar treatment. Customised processes can then be designed for each segment, with dedicated expert teams managing the risk. Segmentation also facilitates effective monitoring and reporting. Significant Institutions are therefore expected to fully segment their portfolios at a granular level in order to identify which sectors are more vulnerable to the current crisis. Within these sectors, Significant Institutions should also segment their portfolios, for example to identify which borrowers are viable and which are non-viable.

- **Strategy**: Following the full segmentation of their portfolios, Significant Institutions are expected to devise a comprehensive strategy to deal with the risks they face from this pandemic. The strategy should have both a short and medium-term focus and include a range of solutions which can be applied depending on both the situation of the borrower and the risk appetite of the institution. The implementation of the strategy and the related solutions should be monitored and tested to ensure they are effective and realistic.

- **Operational capacity and expertise**: Early arrears management and borrower engagement is crucial to limit the impact on the broader portfolio by granting new facilities, restructuring existing facilities or working out the exposures in a timely manner in order to maintain the value of the firm and/or collateral.

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2  See Article 76(2) of Directive 2013/36/EU.
value. Significant Institutions are therefore expected to devote sufficient resources with adequate expertise to borrower engagement and risk management, in proportion to the level of expected risk.

These core elements of risk management should be assessed on an ongoing basis and adapted according to the evolution of risk in the Significant Institutions’ portfolios.

Joint Supervisory Teams will engage in more detailed discussions with Significant Institutions in the coming months in order to assess their risk management practices.

This letter aims to provide clarity on how the quality of loan portfolios should be managed in the specific context of the COVID-19 pandemic and to remind Significant Institutions to follow the applicable regulatory requirements regarding risk management practices.

We encourage that the content of this letter is discussed by your institution’s board of directors. The JST would appreciate to receive a response to this letter, approved by the board of directors, before 15 September 2020.

Yours sincerely,

[signed]

Andrea Enria