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GUVERNER

Reg. No: 348/020/20-7/BV

Zagreb, 21 May 2020

TO ALL CREDIT INSTITUTIONS

Attention of: Management Board

Subject: Addendum to the Circular of the Croatian National Bank (Reg. No. 180-020/19-03-20/BV) dated 19 March 2020 on the COVID-19 pandemic in the context of the subsequently published documents of the European Banking Authority and the European Securities and Markets Authority

Dear Sir/Madam,

Immediately after the World Health Organisation declared COVID-19 a global pandemic on 12 March 2020, the Croatian National Bank (hereinafter: the CNB) sent to all credit institutions a circular *Adjustments of certain supervisory activities, extension of deadlines for the implementation of supervisory measures and supervisory expectations regarding the classification of exposures in response to coronavirus pandemic* (Reg. No.: 180-020/19-03-20/BV, hereinafter: the March circular) on 19 March 2020, and a letter (Reg. No.: 348/020/20-03/BV; hereinafter: the earthquake circular). In addition, the CNB published responses to queries related the implementation of the March circular¹, in particular as regards numerous disclosures by European institutions which, like the CNB, focused on avoiding the cliff effect of the COVID-19 outbreak on the operation of credit institutions, in the part related to the classification and disclosure of non-performing and forborne exposures and the treatment of moratoria on exposures classified as performing as at 31 December 2019. The objective of this circular (hereinafter: the May circular) is to further specify the supervisory expectations of the CNB, in line with the interpretations of the method of classification and disclosure of non-performing and forborne exposures and the treatment of moratoria published in the documents of the European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA) after the March circular.

AMENDMENT TO SUPERVISORY EXPECTATIONS FROM THE MARCH CIRCULAR OF THE CNB

The May circular of the CNB supplements the March and earthquake circulars, and defines supervisory expectations of the CNB as regards credit institutions' obligations, which, as of 20 May 2020, include:

- the disclosure of moratoria granted by credit institutions as of 1 January 2020 to clients whose exposures were classified as non-performing as at 31 December 2019;

¹ https://www.hnb.hr/documents/20182/636841/h-odgovori-na-upite-COVID-19_okruznica.pdf/01ad0dd0-8638-e3b7-c1ad-667854bf2ab?t=1585917298305

- the obligation of credit institutions to notify the CNB of changes in internal policies on criteria and indicators applied in the classification of exposures into forborne, carried out due to the COVID-19 pandemic or the earthquake;
- the obligation of credit institutions that their expected credit loss (ECL) models applied to performing exposures mirror the deterioration of macroeconomic projections caused by the COVID-19 pandemic and the earthquake.

DISCLOSURES OF MORATORIA ON NON-PERFORMING EXPOSURES

On 2 April 2020, the EBA published the *Guidelines on legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis* (EBA/GL/2020/02, hereinafter: EBA Guidelines²) that specify the prudential treatment of legislative and non-legislative moratoria on (postponement of) loan repayments granted in response to the COVID-19 pandemic in the context of the application of the definition of default in accordance with Article 178 of Regulation (EU) No 575/2013 (hereinafter: Regulation) and classification of forbearance in accordance with Article 47b of that Regulation. Furthermore, the EBA Guidelines supplement the EBA Guidelines on the application of the definition of default (EBA/GL/2016/07) as regards the treatment of distressed restructuring.

The CNB expects credit institutions to implement the EBA Guidelines as well as that moratoria which meet the criteria³ defined in the EBA Guidelines should not in itself change the classification of exposures under the definition of forbearance in accordance with Article 47b of Regulation (EU) No 575/2013 or change whether they are treated as distressed restructuring in accordance with Article 178(3)(d) of that Regulation. Specifically, a **preferential treatment** is applied to moratoria that meet the above-mentioned criteria given that they in itself do not provide the basis for:

- the classification of exposures into B or C risk categories in accordance with the Decision on the classification of exposures into risk categories and the method of determining credit losses (OG 114/2017 and 110/2018, hereinafter: the Decision), or
- the classification of exposures as forborne (either performing or non-performing) unless an exposure has already been classified as forborne at the moment of the application of the moratoria.

Given that the EBA Guidelines were published after the March circular, credit institutions may apply “preferential treatment” to moratoria that meet the criteria defined in the EBA Guidelines, granted in

²See

https://eba.europa.eu/sites/default/documents/files/document_library/Publications/Guidelines/2020/Guidelines%20on%20legislative%20and%20non-legislative%20moratoria%20on%20loan%20repayments%20applied%20in%20the%20light%20of%20the%20COVID-19%20crisis/Translations/882518/EBA-GL%20Guidelines%20on%20payment%20moratoria_COR_HR.pdf

³ Credit institutions may grant these moratoria to a large group of debtors or exposures predefined on the basis of broad criteria. Examples of such broad criteria may include a specific exposure class (e.g. retail, private individuals, SMEs or corporates), a specific product range (e.g. housing loans) or debtors from specific regions or certain industry sectors that are most affected by the COVID-19 pandemic or the earthquake.

response to the COVID-19 pandemic or the earthquake (as defined in the letter of the CNB Reg. No.: 348/020/20-03/BV, hereinafter: the earthquake circular), by 31 March 2021, regardless of their risk category at the moment of the application of the moratoria.

Moreover, in contrast to the March and earthquake circulars, the EBA Guidelines do not define the criteria applied in the assessment whether business operation or revenue generation of credit institutions' clients has already been affected or is expected to be affected by the COVID-19 pandemic. Therefore, credit institutions are free to independently define additional criteria of affectedness and to apply "preferential treatment" in line with the EBA Guidelines to clients subject to the moratoria applied before 31 March 2021 (e.g. pensioners affected by the COVID-19 pandemic).

Finally, credit institutions may apply "preferential treatment" to all subsequently agreed moratoria defined at the level of a large group of debtors or exposures (such as the initiative for tourism exposures), provided that they are compatible with the EBA Guidelines.

DISCLOSURE OF EXPOSURES RECLASSIFIED AS NON-PERFORMING AND FORBORNE

The March circular and earthquake circulars additionally define the classification and disclosure of performing exposures by credit institutions, but they do not define the method of disclosing forborne exposures to the CNB in the context of the COVID-19 pandemic and the applicable supervisory regulations⁴. Thus, where credit institutions grant forbearance measures to exposures (excl. moratoria on/postponement of repayments) or to new specific exposures (to the existing or new clients) that meet the criteria set out in the CNB circulars, they are required to review them adequately within the framework of Article 47b of Regulation.

In accordance with the March and earthquake circulars, where credit institutions reclassify exposures classified into risk category A as at 31 December 2019 into risk category B or higher risk category, they may apply the criteria of more than 90 days past due on any material credit obligation as the mandatory criteria by 31 March 2021. This is substantiated by the fact that the CNB understands that by 31 March 2021, in addition to the 90-day default on collection of claims, credit institutions may experience difficulties in monitoring other indicators which would indicate the need for the reclassification of exposures classified into risk category A as at 31 December 2019 (performing exposures) into risk category B or higher risk category (non-performing exposures) due to uncertainty, unreliability and incompleteness of the available data. The CNB maintains the same position as regards the reclassification that includes the assessment whether the above-mentioned debtors are experiencing or are likely to experience difficulties in meeting their financial commitments in accordance with Article 47b.

In line with this treatment, where credit institutions have reliable information that short-term challenges debtors are exposed to due to the COVID-19 pandemic or the earthquake are evolving into long-term financial difficulties, they have to incorporate it into the assessment of the classification of debtors and

⁴ See <https://eur-lex.europa.eu/legal-content/HR/TXT/?uri=CELEX%3A32014R0680>

exposures to debtors. In addition, where credit institutions negotiate concessions with debtors on an individual basis, taking into account the assessments of their creditworthiness, they are required to assess whether concessions constitute a forbearance measure as provided for in Article 47b of Regulation.

Accordingly, where credit institutions establish that exposures classified into risk category A as at 31 December 2019 or new exposures to clients, whose business operation is affected by the COVID-19 pandemic or the earthquake, meet conditions for reclassification as forborne in accordance with Article 47b, they are required to reclassify them accordingly.

Credit institutions are requested to notify the CNB promptly and without delay of all changes in internal policies on criteria and indicators applied in the reclassification of exposures as non-performing (B or higher risk category) or as forborne (in accordance with Article 47b) that were carried out after 19 March 2020 due to the COVID-19 pandemic or the earthquake or that will be carried out by 30 June 2021.

ACCOUNTING ASPECTS OF THE IMPLEMENTATION OF THE CIRCULARS AND THE EBA GUIDELINES

Since the International Financial Reporting Standard 9 – Financial Instruments (hereinafter: IFRS 9) is based on the principles, the CNB believes that credit institutions in the existing situation can apply the flexibilities that this accounting standard allows, in order to properly reflect the specific circumstances of the COVID-19 pandemic and the earthquake as well as the measures taken by the Government of the RC and government institutions to mitigate the effect of the pandemic and the earthquake on the Croatian economy. These measures address the short-term limitations of debtors resulting from the pandemic and the earthquake, and at this point it is extremely difficult to reliably assess their impact on credit risk over the expected life of exposures subject to the classification and valuation.

IFRS 9 requires credit institutions to assess at each reporting date whether there has been a significant increase in credit risk (SICR) since the initial recognition of exposures. The CNB believes that the SICR is a holistic assessment of a range of quantitative and qualitative indicators (IFRS 9, paragraph B5.5.17) which are to address changes in the risk of default over the expected life of loans. Moreover, measures taken by credit institutions under the March circular or the earthquake circular or the EBA Guidelines should not be automatically, in itself, regarded as a SICR indicator, and if reliable forward-looking information on the economic situation of credit institutions' clients is not available without undue cost or effort, credit institutions may base their estimates on past due information (IFRS 9, paragraph 5.5.11). However, the CNB expects credit institutions to carefully consider whether specific circumstances related to the outbreak of the pandemic or the earthquake or the related economic support and relief measures provided under individual circumstances constitute sufficient justification for the use of this approach. If, for the reasons set out above, credit institutions are not able to perform the SICR assessment on an individual exposure level, the assessment is to be performed on the level of the portfolio of exposures of similar characteristics (IFRS 9, paragraphs B5.5.1 – B5.5.5).

After the March circular issued by the CNB, the ESMA issued a public statement *Accounting implications of the COVID-19 outbreak on the calculation of expected credit losses in accordance with IFRS 9*⁵ on 25 March 2020 in order to promote consistent application of the relevant IFRS 9 provisions in the specific context of the COVID-19 outbreak and measures taken by governments of Member States to mitigate the economic impact of the COVID-19 (hereinafter: the ESMA public statement). The above-mentioned measures also include moratoria on loan repayments affecting the calculation of expected credit losses in the light of IFRS 9 provisions. The ESMA public statement is consistent with the EBA statement on the application of the prudential framework and the accounting implications of the COVID19.⁶

In view of annual and other periodic financial statements to be published by credit institutions in the upcoming period, the ESMA public statement provides guidance to issuers and auditors on the application of IFRS 9 – Financial Instruments, especially as regards the calculation of expected credit losses and related disclosure requirements.

In accordance with the ESMA public statement, credit institutions are requested to pay particular attention to the delineation between measures taken as a result of the impact of COVID-19 on the operation of involved participants and measures taken independently of the impact of the virus, i.e. as a result of temporary liquidity constraints experienced by clients independently of the virus itself. Where specific measures are not provided for in the provisions of IFRS 9, credit institutions are requested to develop their own accounting policies in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

In view of the ESMA public statement and the increased uncertainty regarding short-term macroeconomic projections, the CNB expects credit institution:

- to give a greater weight to long-term macroeconomic projections when calculating expected credit losses (ECL) and to take into account
- the economic support and relief measures of the Government of the RC as well as
- the official macroeconomic projections of the CNB and the European Central Bank when making their own macroeconomic projections.

As a result, credit institutions are requested to notify the CNB promptly and without delay as well as in an appropriate manner of:

- the impact of deterioration of macroeconomic indicators, caused by the COVID-19 outbreak and the earthquake, on ECL models applied to performing exposures, and

⁵ See <https://www.hanfa.hr/vijesti/esma-izdala-javnu-objavu-o-ra%C4%8Dunovodstvenom-utjecaju-covid-19-na-izra%C4%8Dun-o%C4%8Dekivanih-kreditnih-gubitaka-sukladno-msfi-9/>

⁶ See https://eba.europa.eu/sites/default/documents/files/document_library/News%20and%20Press/Press%20Room/Press%20Releases/2020/EBA%20provides%20clarity%20to%20banks%20and%20consumers%20on%20the%20application%20of%20the%20prudential%20framework%20in%20light%20of%20COVID-19%20measures/Statement%20on%20the%20application%20of%20the%20prudential%20framework%20Regarding%20Default%2C%20Forbearance%20and%20IFRS9%20in%20light%20of%20COVID-19%20measures.pdf

- any changes in accounting policies that define the method of calculation of expected credit losses, carried out after 19 March 2020 as a result of the COVID-19 and the earthquake.

CONCLUSION

In order to facilitate the implementation of supervision expectations, the circular includes two annexes which:

- define the reclassification of exposures classified as performing as at 31 December 2019 into forborne or non-performing exposures after 20 May 2020, and
- define the relationship between the March circular and the EBA Guidelines.

In particular, given the scarcity of available and reliable information in the current context of the COVID-19 pandemic and the recovery from the earthquake, the CNB is aware that credit institutions will experience difficulties in generating reasonable and supportable short-term economic forecasts and encourages them to give a greater weight to long-term forecasts based on past experience, taking into account the measures taken by government institutions to mitigate the effect of the pandemic and the earthquake on the economy as a whole.

Kind regards,

Boris Vujčić
Governor

Annexes:

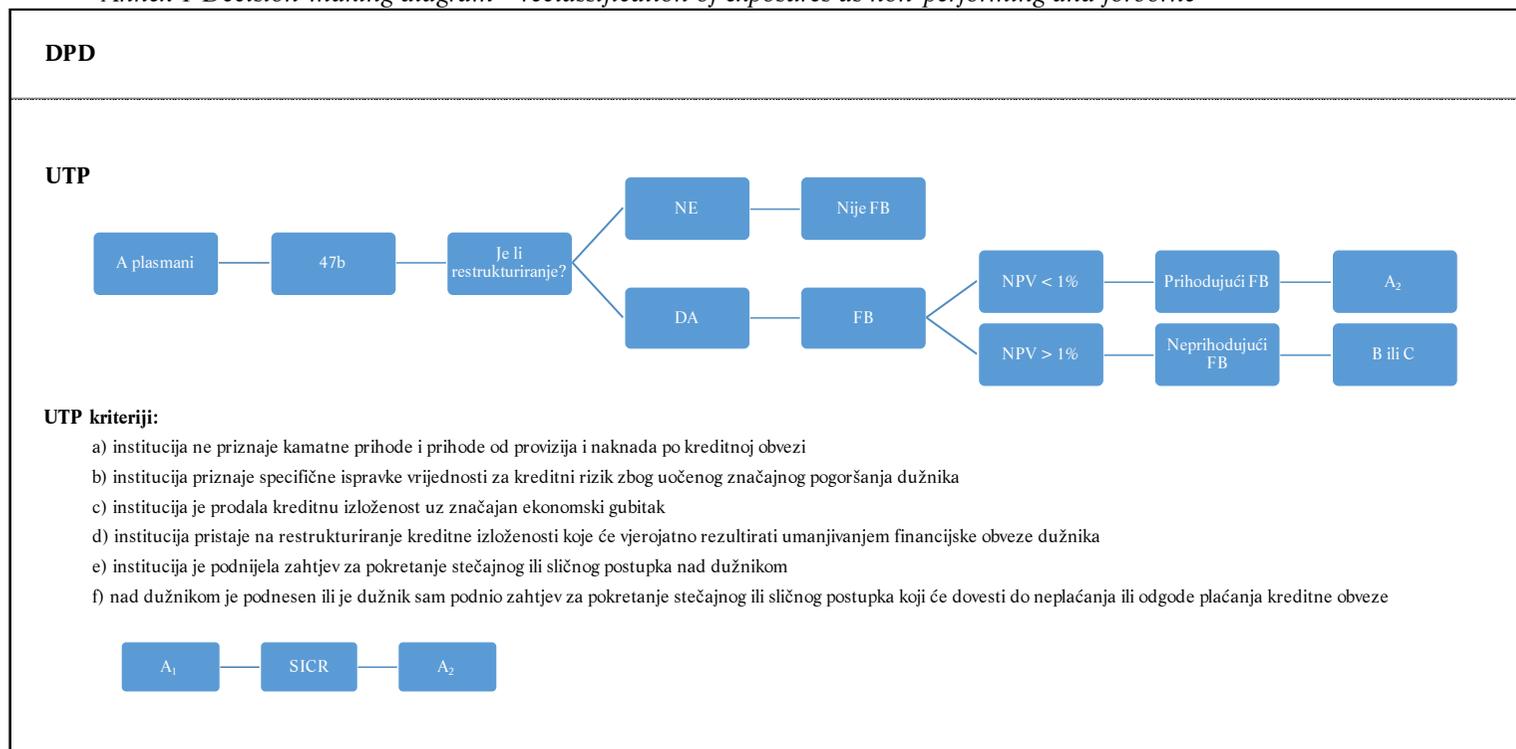
Annex 1

Decision-making diagram – reclassification of exposures as non-performing and forborne

Annex 2

Overview of the relationship between the implementation of the EBA Guidelines, the March circular and the May circular

Annex 1 Decision-making diagram – reclassification of exposures as non-performing and forborne



DPD (*days past due*) – days past due as provided for in Article 178(1)(b) of Regulation (EU) No 575/2013

UTP (*unlikely to pay*) – the debtor is unlikely to pay its credit obligations in full as provided for in Article 178(1)(a) of Regulation (EU) No 575/2013

FB (*forbearance*) – forbearance as provided for in Guidelines on management of non-performing and forborne exposures

SICR (*significant increase in credit risk*) – significant increase in credit risk as provided for in IFRS 9 – Financial Instruments



NPV (*net present value*) – net present value

A (A1 and A2), B and C placements – placements classified into risk categories A(A1 and A2), B and C as provided for in the Decision on the classification of exposures into risk categories and the method of determining credit losses (OG 114/2017 and 110/2018)

47b – Article 47b of Regulation (EU) No 575/2013

Annex 2

Overview of the relationship between the implementation of the EBA Guidelines, the March circular and the May circular

SUBJECT	MARCH CIRCULAR AND EARTHQUAKE CIRCULAR	EBA GUIDELINES	METHOD OF OPERATION	REFERENCES – CNB RESPONSES TO QUERIES RELATED TO CNB COVID-19 CIRCULAR
Affectedness condition	Define affectedness condition	Do not define affectedness condition	Credit institutions may apply the criteria set out in the circulars, but may also independently establish the criteria and evidence of affectedness in line with the criteria set out in the EBA Guideline and the circulars.	66, 73, 85, 86
Method of implementation	Provides an individual approach by a credit institution and a coordinated approach across several institutions	Paragraph 10(a) defines legislative and non-legislative moratoria	Credit institutions are free to act in accordance with the circular and in accordance with the EBA Guidelines.	62



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Scope – range of clients	Do not define the method of implementation of measures set out in the circular	Paragraph 10(b) defines a group of debtors that take advantage of the moratorium without the assessment of their creditworthiness	Credit institutions may apply the measures to a large group of debtors predefined on the basis of broad criteria, where any criteria for determining the scope of application of the measures should allow a debtor to take advantage of the measures without the assessment of its creditworthiness.	87, 89
Scope – classification	Defines the assessment of exposures not classified into B or C risk categories as at 31 December 2019	Paragraph 10(b) defines performing and non-performing exposures	Credit institutions are free to apply the treatment set out in the circulars to the moratoria on exposures classified into B or higher risk category on the day of the application of the moratoria, unless an exposure has already been classified as forborne.	5, 19, 35, 63
Type of measure	Refers to postponement of repayments/moratoria without the definition of changes in loan terms	Paragraph 10(c) and paragraph 10(d) define changes in loan terms	Where moratoria on or postponement of repayments meet criteria set out in the EBA Guidelines or the circulars and apply to all exposures of the institution falling within the scope of application of the moratoria regardless of the assessment of debtors' creditworthiness, such measures should not in itself change the classification of exposures under the definition of forbearance in accordance with Article 47b of Regulation (EU) No 575/2013 or change whether they are treated as distressed restructuring in accordance with Article 178(3)(d) of that Regulation, i.e. they should not in itself lead to the reclassification of exposures into B or C risk categories.	9, 11



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Time limits for implementing measures	Defines moratoria granted by 31 March 2021	Define moratoria granted by 30 June 2020	In line with the circulars, measures from the circulars may be implemented by 31 March 2021, and credit institutions are free to combine any of the measures set out in the circulars in the period from 20 March 2020 to 31 March 2021, provided that the criteria from the circulars are met	1, 82
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