HNB

GUVERNER

Reg. No: 348/020/20-9/BV

Zagreb, 23 December 2020

TO ALL CREDIT INSTITUTIONS

Attention of: Management Board

Subject: **Addendum to the Circular of the Croatian National Bank Reg. No. 348/020/20-7/BV dated 21 May 2020 on the COVID-19 pandemic in the context of the subsequently published documents of the European Banking authority and the European Central Bank**

Dear Sir/Madam,

Further to the circulars issued by the Croatian National Bank thus far (hereinafter: CNB) and recently issued recommendations of the European Banking Authority (hereinafter: EBA) and recommendations and supervisory expectations of the European Central Bank (hereinafter: ECB) in relation to the COVID-19 pandemic, we would hereby like to communicate the following:

a) guidelines for the operation of credit institutions directly supervised by the ECB (significant institutions) and

b) supervisory expectations and recommendations for credit institutions directly supervised by the CNB (less significant institutions).

I. SIGNIFICANT INSTITUTIONS

On 4 December 2020, the ECB sent significant institutions its expectations relating to the identification and measurement of credit risk in the context of the coronavirus (COVID 19) pandemic (SSM-2020-0744) and on 15 December 2020 issued the Recommendation on dividend distributions during the COVID-19 pandemic (ECB/2020/62).

Credit institutions under direct supervision of the ECB are expected to fully implement the said recommendations and supervisory expectations published on the ECB's website, at the following links:

Supervisory expectations relating to identification and measurement of credit risk

https://www.bankingsupervision.europa.eu/press/letterstobanks/shared/pdf/2020/ssm.2020_letter_credit_risk_identification_measurement~734f2a0b84.en.pdf?c839e6212e8a9bf18dc0d26ab0b1cd7f

Supervisory recommendation on dividend distributions

https://www.bankingsupervision.europa.eu/ecb/pub/pdf/en_ecb_2020_62_f_sign~6a404d7d9c..pdf

The CNB would like to draw the attention of significant credit institutions to national regulations applicable in the Republic of Croatia, i.e. that:

- in accordance with Article 20, paragraph (6) of the Credit Institutions Act holders of shares of a credit institution are obligated in exercising their rights attached to shares to act in the interest of the credit institution;

- Articles 312a to 312c of the Credit Institutions Act prescribe the protection of depositors in cases when the credit institution adopts a decision on payments which reduce common equity tier 1 capital items.

II. LESS SIGNIFICANT INSTITUTIONS

Further to:
- earlier mentioned ECB notifications and
- CNB circulars on supervisory expectations (Reg. No. 180-020/19-03-20/BV, 348/020/20-03/BV, 348/020/20-7/BV – hereinafter: circulars) that the CNB issued for the purpose of avoiding the cliff effect of the COVID-19 pandemic 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; and
- amendment of EBA Guidelines on legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis (EBA/GL/2020/15; hereinafter: EBA Guidelines)

we would hereby like to clarify to credit institutions not directly supervised by the ECB
- our supervisory expectations relating to:
  - granting of moratoria as from 1 October 2020: possible application of the preferential treatment until 31 March 2021, provided that the cumulative duration of the moratorium does not exceed 9 months;
  - treatment of moratoria in the context of classification in forborne placements: assessment of the SICR and the UTP criteria and the CNB's monitoring in accordance with the COVID Score;
  - determining of impairments and provisions for exposures: including their mapping by model and expected increase in credit risk;
  - credit risk management system: clear objectives for monitoring and reporting to the management on exposures affected by the COVID-19 pandemic;
- our recommendations regarding:
  - dividend payments: no dividend payments (either from profit or retained earnings) at least until 30 September 2021; and
  - variable remuneration: postpone incentives and bonuses after the materialisation of credit risks associated with the COVID-19 pandemic.

This circular hereby amends the above-mentioned circulars relating to:
- the treatment of moratoria granted after 1 October 2020;
- credit institutions' improvement of procedures in order for all amendments to contracts that meet the forbearance criteria referred to in Article 47b of Regulation (EU) No. 575/2013 to be classified as forborne (hereinafter: FB status) in credit institutions' systems;
- regular assessment of the unlikeliness of borrowers to pay their obligations (hereinafter: UTP criteria) and improvement of existing procedures, UTP criteria and indicators of credit institutions in the current situation;
- timely assessment and recording of each significant increase in credit risk of the borrower (hereinafter SICR) and assessment of required provisions based on realistic parameters and assumptions reflecting the existing situation;
- governance arrangements enabling adequate supervision of all key elements of credit risk management in the existing situation and adjustment of strategic and operating plans to the existing situation;
- payment of dividends and variable remuneration; and
- reporting to the Croatian National Bank on the manner in which the expectations referred to in this circular are met.

A. TREATMENT OF MORATORIA GRANTED AFTER 1 OCTOBER 2020

The CNB expects the moratoria granted by credit institutions after 1 October 2020 and prior to 31 March 2020 to be subject to the treatment from previous circulars under the additional condition that the duration of the moratoria does not exceed 9 months. This requirement shall not apply to moratoria contracted prior to 30 September 2020.

B. IMPROVEMENT OF PROCEDURES FOR DETERMINING FB STATUS

The CNB expects from credit institutions to improve procedures for determining the FB status in such a manner that every concession to borrowers experiencing a) difficulties in meeting their financial obligations or likely to experience them and which can b) lead to loss for the credit institution to be adequately classified in their system as forbearance measures. All changes to contractual conditions that do not comply with conditions for the application of EBA Guidelines should be assessed on a case-by-case basis in order for the credit institution to determine whether the exposure should be classified as forborne in the credit institution's system in accordance with Article 47b of Regulation (EU) No. 575/2013.

Credit institutions should adapt their systems in order to identify borrowers experiencing difficulties in meeting their financial obligations or likely to experience them in a timely manner. For borrowers currently not experiencing difficulties in meeting their financial obligations credit institutions are expected to assess whether market conditions have changed to an extent that would make it likely that the borrower would have difficulties in meeting their financial obligations. Although it does not in itself mean that borrowers granted moratoria under the EBA Guidelines have a FB status, the CNB expects from credit institutions that such borrowers and their exposures be flagged in a credit institution's system so they can be monitored and reported. A borrower's FB status must also be reflected in supervisory and accounting classifications of the borrower.

C. REGULAR ASSESSMENT OF THE BORROWERS UNLIKELINESS TO MEET THEIR OBLIGATIONS (UTP CRITERIA) AND RATING SYSTEMS

Amid conditions of the lack of data on borrower delinquency and decreased reliability of financial information, the CNB expects credit institutions to improve their existing processes for determining the UTP criteria in the following manner:

- to give priority to the expert assessment of the UTP criteria for borrowers significantly affected by the COVID-19 pandemic;
- to employ in a structured manner that can be monitored and updated comprehensive sources of information including data on received relief measures, employment status of natural persons, credit risk development in the economic activity in which the natural person is employed, etc. (sources of such data may be, for example, the COVID Score published by FINA, data obtained directly from clients, data obtained from publicly available sources, etc.).
- to perform more frequent assessment of high-risk borrowers;
- for borrowers that have been granted moratoria in accordance with EBA Guidelines to asses during the period of that moratoria the UTP criteria and after the expiry of the moratoria make a priority assessment of those borrowers whose payments were delinquent or that apply for a new concession immediately after the expiry of the moratoria.

The CNB expects credit institution's to review the impact of the COVID-19 pandemic and measures aimed at containing the impacts of the COVID-19 pandemic on the rating process and quantification of risk parameters. The granted moratoria must not lead to an improvement in risk parameters in comparison to those recorded prior to the COVID-19 pandemic. Further, forbearance in relation to moratoria not granted under the EBA Guidelines should be reflected in the assigned rating via the conservative approach. Should indicators that indicate deeper recession materialise, the potential upward correction of LGD and conversion factors enables adequate risk management in the existing situation.

D. TIMELY IDENTIFICATION AND RECORDING OF EACH SIGNIFICANT INCREASE IN THE CREDIT RISK OF A BORROWER (SICR CRITERIA) AND ASSESSMENT OF REQUIRED PROVISIONS

The CNB expects from credit institution to build their assessment of required provisions on realistic parameters and assumptions reflecting the existing situation. In accordance with the International Financial Reporting Standard 9 – *Financial Instruments* (hereinafter: IFRS 9), credit institutions are expected to assess at each reporting date whether it has come a significant increase in credit risk since the initial recognition of an exposure. If reliable forward-looking information is available without undue cost or effort, in determining the SICR criteria credit institutions may not base their estimates solely on past due information. In an attempt to define its supervisory expectations in more detail without relaxing the existing accounting rules, the CNB expects credit institutions to continue calibrating their baseline scenarios in accordance with the CNB's and ECB's macroeconomic projections without bias. If reliable macroeconomic projections for individual years exist, the CNB expects credit institutions not to rely only on long-term averages i.e. through-the-cycle approach.

Regardless whether a credit institution assesses the SICR criteria on an individual or collective basis and whether a particular exposure is subject to a moratorium in accordance with EBA Guidelines, a credit institution is expected to assess the SICR criteria referred to in paragraphs B5.5.1 – B5.5.18 and Appendix A to IFRS 9 in a comprehensive manner.
In relation to the assessment of the SICR criteria amid the pandemic, the CNB expects from credit institutions in particular:

– that for exposures which have been granted moratoria in accordance with EBA guidelines the SICR indicators are monitored in a comprehensive manner; because delinquency data are influenced by the moratoria and delinquency days are calculated pursuant to a new repayment schedule;
– where a credit institution grants the borrower forbearance measures (FB measures) not in accordance with EBA Guidelines, these measures should be an indicator for the transfer of the exposure into Stage 2, except in cases where the credit institution, through individual assessment of a borrower's creditworthiness established that it has not come to a significant increase in the credit risk of the exposure;
– to consider all exposures with payment delinquencies over 30 days as exposures in Stage 2, except where a credit institution pursuant to reliable data and individual assessment of a borrower's creditworthiness proves that it has not come to a significant increase in the credit risk of the exposure;
– to use qualitative data in addition to statistical data to establish whether it has come to a significant increase in the credit risk of an exposure;
– not to smooth out the transfer of exposures between stages by using targeted transfer amounts or reverse engineering in order to meet these target amounts; we stress that the criteria for transfer between stages should not be based exclusively on the absolute level of PD or absolute increase in PD (IFRS 9, B.5.5.9);
– that internally set levels of SICR indicators are in line with good practices established since the introduction of the IFRS 9 and that they are not relaxed when portfolio quality shrinks or becomes unstable and that they continue to be consistent across portfolios and in no way favour riskier borrowers; in connection to the latter, institutions should apply triple increase in lifetime (annualised PD as a backstop SICR criterion;
– due to heightened uncertainty credit institutions will sometimes have to employ subjective model inputs and subsequent model corrections. However, we would like to stress that these subjective model inputs and subsequent model corrections have to be consistent with objective and substantiated factors, such as realised macroeconomic indicators and long-term projections; since borrowers are differently

affected by the COVID-19 pandemic, depending on their economic sector, macroeconomic indicators in one sector may indicate a significant increase in credit risk of an exposure to borrowers in this economic sector; credit institutions may transfer the exposure to Stage 2 based solely on this criterion, provided they do not have available more detailed information proving that individual exposures to debtors in this economic sector may remain in Stage 1;

– in accordance with the previous item, where due to the lack of individual information on a particular borrower it is impossible to carry out an individual assessment of the creditworthiness of the borrower, a credit institution should assess the SICR criteria using the top-down and bottom-up approach; and
– to avoid overrides of adopted quantitative approaches for the assessment of the SICR criteria by management boards, that is, that they are possible only subject to strict governance arrangements and model validation and applied only to a smaller portion of the portfolio within a limited period of time.

E. GOVERNANCE ARRANGEMENTS

The CNB expects credit institutions to employ governance arrangements that enable adequate supervision of all credit risk management elements in the existing situation and adjustment of strategic and business plans to the existing situation. Control functions, including internal audit, should include in their plans the assessment and monitoring of internal procedures that have been adjusted due to the pandemic. The management of a credit institution is expected to analyse the projections of the impact of the pandemic on the allocation of exposures to stages, the coverage of exposures by impairments and provisions and the impact of the COVID-19 pandemic on the credit institution's capital adequacy.

F. POLICIES OF REFRAINING FROM DIVIDEND AND OTHER PAYMENTS

Since in exercising their shareholder rights shareholders are expected to act in the interest of the credit institution, the Croatian National Bank expects from credit institutions to refrain from a) dividend payments, b) share buy-backs and c) variable remuneration payments until 30 September 2021.

We would like to stress herewith that credit institutions are expected to submit an application to the Croatian National Bank at least three months prior to the announcement of share buy-backs and that share buy-backs cannot be effected without the prior approval of the Croatian National Bank. Further, the Croatian National Bank would like to underline that Articles 312a to 312c of the Credit Institutions Act prescribe the protection of depositors in cases where a credit institution adopts a decision on payments which reduce common equity tier 1 capital items referred to in Article 26, paragraph (1), items (c), (e) and (f) of Regulation (EU) No 575/2013.

G. CONCLUSION

The CNB would like to stress that positions expressed in this circular serve only as the reminders of obligations arising from the existing regulatory framework and as such should be reflected in regulatory reporting in this reporting year as well as in the credit institution's strategic plans and budgets. This circular supplements the CNB's expectations expressed in previous circulars in accordance with Amended EBA Guidelines (EBA/GL/2020/15) as well as expectations specified by the ECB and in accordance with the potential increase in exposures to risks arising as a result of the second wave of the coronavirus pandemic.

Credit institutions are instructed to make the members of their supervisory boards acquainted with the content of this circular as they are expected to comment on it.

The CNB expects credit institutions to notify the CNB by 31 January 2021, at the latest, on the manner of fulfilling expectations referred in this circular, ensuring an adequate level of qualitative and quantitative details to enable the CNB to assess whether a credit institution meets expectations specified in this circular.

The notification is expected to be structured into the following chapters:

- general comments;
- assessment of the FB status and UTP criteria;
- allocation of exposures to stages and assessment of provisions in accordance with IFRS 9;
- financial projections used in risk management systems;
- rating systems and quantification of risk parameters; and
- governance arrangements and inclusion of management bodies.

The CNB will analyse the notification obtained from the credit institution and, in supervisory dialogue with the credit institution, deliberate further supervisory activities including the imposition of adequate supervisory measures (which may include measures referred to in Article 224, paragraph (1), under (11) – the application of a specific provisioning policy or treatment of assets in terms of own funds requirements; under (28) – order a correct evaluation of on- and off-balance sheet items, as well as other supervisory measures).

Kind regards,

Boris Vujčić
Governor