Payment Moratoria and State Guarantee Scheme: A review of two key tools in response to the COVID-19 crisis

Introduction

In response to the spread of COVID-19 across the globe, a variety of economic relief measures have been taken and proposed by national governments and EU bodies in order to support individuals, households and businesses affected by the crisis and facing difficulties with the timely repayment of their financial commitments.

As Luxembourg is approaching the six-month milestone since the government declared the state of crisis, the time has come to reflect on two of the principal relief measures[1] that have been available in Luxembourg since 18 March 2020, namely (I) moratoria on repayment of loans[2] and (II) public loan guarantees.[3] These two tools can be combined, such that a government-guaranteed loan can be obtained in addition to a moratorium on existing loans, which some Luxembourg banks have undertaken to grant.

Last June, three months after the implementation of both COVID-19 measures, the Luxembourg Minister of Finance provided the members of the Finance and Budget Committee (a parliamentary committee) with data on the actual use of these measures by companies. He suggested that the new moratoria measures have been a great success so far, with approximately 17,000 requests made by Luxembourg companies for an aggregate value of around EUR 3.5 billion, and an acceptance rate of 95%. On the other hand, the Minister indicated that only half of the applications for a bank loan with the Luxembourg State (approximately 200) have been successful. The grounds for refusal have not been disclosed, since the State has a certain margin of discretion when deciding whether or not to grant a loan. The Luxembourg Minister of Finance also specified that in practice, requests for public loan guarantees were mainly made by retail trade and food & beverage businesses, while guaranteed loans generally amounted to approximately EUR 250,000 each and were subject to an interest rate of between 1.5% and 3%.

The following paragraphs aim to provide a review of the rules shaping bank moratoria and State-guaranteed loans since the beginning of the state of crisis.

I. Luxembourg Bank's Moratoria on Repayment of Loans

Under Luxembourg ordinary law, a moratorium can be granted to debtors in order to suspend payment of their debts for a fixed period of time. Such an exceptional measure can result from either protective legal provisions against creditors[4] or contractual agreements reached with one or several creditors[5]. Although moratoria can be granted by a vast array of creditors, banks are the most obvious type of institution expected to grant them.

Even if moratoria have beneficial effects on the recovery of businesses hit by the COVID-19 crisis, they could have unwanted consequences for EU credit institutions' regulatory requirements. In that respect, the European Banking Authority adopted guidelines on 2 April 2020 regarding legislative and non-legislative moratoria on loan repayments applied in light of the COVID-19 crisis[6] (the "**EBA Guidelines**")

The EBA Guidelines aim at ensuring consistent regulatory treatment between moratoria on loan repayments, which are traditionally adopted in various forms across jurisdictions (either as jurisdiction-wide moratoria introduced by some EU Member States or as industry-wide payment relief initiatives taken by EU credit institutions). The *Commission de Surveillance du Secteur Financier* ("**CSSF**") integrated the EBA Guidelines into its administrative practice and regulatory approach pursuant to Circular CSSF 20/741 of 30 April 2020 (which was amended by Circular CSSF 20/749 of 28 July 2020).

These prudential rules are of significant interest in Luxembourg given that the *Association des Banques et Banquiers Luxembourgeois* (ABBL), the bankers' association in Luxembourg, contributed to setting up an eligible industry-wide private moratorium initiative on 16 April 2020. The moratoria to be granted accordingly apply to loans to corporate clients, SMEs and individual professionals established in Luxembourg. As a consequence of this initiative, a memorandum of understanding has been signed between the six participating banks[7], pursuant to which financial support in the form of payment moratoria may be provided to certain businesses and associations if specific criteria defined in the memorandum are met, and which complements the state guarantee scheme for new bank loans. Pursuant to this memorandum, a moratorium on the repayment of loans granted before 18 March 2020 can be requested for a maximum of six months by obligors exposed to cash flow difficulties resulting from the current crisis.

Pursuant to the Guidelines, if certain conditions are met, a "*general payment moratorium*" granted in respect of a loan will not trigger any "forbearance" classification for the purpose of calculating the own funds that a credit institution is required to have (see 1 below). Moreover, additional reporting and disclosure requirements are imposed on credit institutions when

granting general payment moratoria (see 2 below). The consequences of the EBA Guidelines for certain issues related to the use of securitisation by credit institutions will also be briefly explained (see 3 below).

1. General Payment Moratoria for the purpose of the EBA Guidelines

The main objective pursued by the EBA Guidelines is to ensure that general payment moratoria on loan repayments will not automatically be characterised as forbearance or default when calculating their required level of regulatory capital. After explaining the concepts of "forbearance" and "default", which both have a bearing on the assessment of the credit risk to which credit institutions are subject in paragraph (a), we will turn to the notion of "general payment moratorium" under the EBA Guidelines in paragraph (b) and the implications of the EBA Guidelines on their regulatory treatment in paragraph (c).

a. Forbearance and default

For the purposes of Article 47b of 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 and amending Regulation (EU) No. 648/2012 (the "**CRR**"), forbearance measures are concessions made by a credit institution towards an obligor that experiences or is likely to experience difficulties in meeting its financial commitments (such as, for instance, the decision by a bank to postpone payments under a loan). Such concessions are based on a previous assessment of the borrower's individual repayment capacity and adapted to their financial circumstances.

The EBA traditionally considers that if forbearance has been extended to a borrower facing or about to face difficulties in meeting its financial commitments, such a measure should be considered as a *"distressed restructuring"* of the credit obligation for the purpose of Article 178(3)(d) of the CRR.[8] This distressed restructuring should be regarded as an *"unlikeliness to pay"* by the obligor if it is likely to result in a diminished financial obligation caused by the material forgiveness, or postponement, of principal, interest or, where relevant, fees. If the credit institution considers that the obligor is unlikely to pay in full, without the institution having recourse to actions such as realising a security, a *"default"* shall be considered to have occurred. As a consequence, the existence of a default will have an impact on the calculation of the capital requirements for credit risk and as the case may be, will force the credit institution to increase its own funds accordingly in order to comply with the regulatory capital requirements.

b. General payment moratorium

The EBA Guidelines provide for a non-exhaustive list of conditions that a moratorium granted by a credit institution has to fulfil in order to be considered a *“general payment moratorium”* for the purpose of the EBA Guidelines and thus to avoid being considered as a *“forbearance”*.

These conditions are as follows:

- the fact that the moratorium was launched in response to the COVID-19 pandemic**;**
- the announcement or application of the moratorium before 30 September 2020[9];
- the broad application of the moratorium by credit institutions, regardless of whether they derive from a legislative or non-legislative initiative;
- the application of the moratorium to a broad range of obligors (i.e. a large, predefined group of obligors, regardless of the assessment of their creditworthiness);[10]
- the application of the same conditions to the same moratoria;
- the limitation of the effects of the moratorium to the change of the schedule of payments under the loan (to the exclusion of the other conditions of the loan (such as the interest rate), unless not doing so would create losses for the credit institution, when applying the amended payment schedule); and
- the pre-existence of the loans eligible for the moratorium (which includes the use of pre-existing credit lines or the renewal of pre-existing revolving credits).

c. Impacts of the EBA Guidelines on qualifying payment moratoria

Where credit institutions grant a moratorium which qualifies as a “general payment moratorium” under the EBA Guidelines, such concession does not trigger the forbearance classification pursuant to the CRR.

As a consequence:

- such a concession does not automatically trigger the classification of the moratorium as a forbearance under Article 47b of the CRR, since the applicability of such a provision to a general payment moratorium will have to be assessed in each specific instance;

- payments under the loan affected by the moratorium should only be considered *"due"* on the date set forth by the revised payment schedule;

- credit institutions should continue to make assessments on the likelihood of the obligor being able to pay its debts. An exposure which is unlikely to be paid should therefore be classified as defaulted (even if it benefits from a general payment moratorium). In this respect, credit institutions should prioritise the assessment of obligors that are most likely to face longer-term financial difficulties or insolvency as a result of the COVID-19 pandemic;

- following the end of the application of the general payment moratorium, credit institutions should again prioritise the assessment of the likelihood of payment where obligors have payment delays or where any forbearance measures are applied, in each case shortly after the end of the moratorium;

- the assessment of likelihood of payment should be based on the applicable revised payment schedule under the general payment moratorium; and

- the assessment of likelihood of payment should not take into consideration additional COVID-19 public support measures (such as government guarantees) even if they meet the requirements for credit risk mitigation, as such measures do not affect the obligor's payment capabilities.

2. Reporting and Disclosure Requirements

In order to help national and European authorities to monitor the implementation of the COVID-19 measures, credit institutions are subject to the following additional reporting and disclosure requirements:

- Credit institutions should report to the CSSF any non-legislative moratorium that they apply, along with specific details, such as (i) the obligors to whom the general payment moratorium was offered, (ii) those to whom such a moratorium was applied, (iii) the level of the exposure affected by the application of the moratorium, and (iv) any economic loss resulting from the application of the moratorium and associated impairment

charges.

- Credit institutions should apply general payment moratoria in a transparent manner, and thus comply with several short-term additional supervisory reporting and disclosure requirements, as set out by the EBA in its guidelines EBA/GL/2020/07 of 2 June 2020, which were integrated by the CSSF into Circular CSSF 20/748 of 20 July 2020. Pursuant to these guidelines, credit institutions should report and disclose information on exposures subject to the EBA Guidelines and on newly originated exposures subject to public guarantee schemes that Member States introduced in response to the COVID-19 crisis. Moreover, institutions should report exposures that are subject to forbearance measures introduced in response to the COVID-19 crisis.

3. Impacts of the EBA Guidelines on securitisations

In a statement published on 22 April 2020[11] (the "**EBA Statement**"), the EBA clarified the extent to which the EBA Guidelines were applicable to some issues relating to the use of traditional or synthetic securitisations by credit institutions. In particular, the EBA indicated the extent to which general payment moratoria will have an impact on exposures of credit institutions which act as initiators of securitisations as set out further under (a) below. The EBA also clarified whether general payment moratoria could be seen as prohibited "implicit support" of securitisation by a credit institution under the CRR, which is dealt with under (b) below.

a. Application of the EBA Guidelines to "exposures of an institution" in a securitisation context

Securitisation is commonly used by EU credit institutions in order to reduce the corresponding amount of their own funds that they are required to maintain pursuant to the CRR. According to Articles 244 and 245 of the CRR, an originator institution can exclude exposures (for traditional securitisation) or the related credit risk (for synthetic securitisation) when calculating the risk-weighted exposure amounts under the conditions set out therein. Therefore, these exposures (or related credit risks) will not have a bearing on the determination of own funds that the credit institution must maintain.

Accordingly, (i) any exposure that remains on the balance sheet of the credit institution or which could not be excluded from the calculation of the risk-weighted exposure amount (for traditional securitisation) and (ii) any underlying exposures in respect of which the credit risk has been transferred should be considered as potentially falling within the scope of a general payment moratorium, as defined in the EBA Guidelines.

Consequently, the EBA Guidelines will apply to such exposures and, as mentioned above, the granting of a general payment moratorium should not automatically trigger the “forbearance” or “default” classifications under the CRR.

b. General payment moratoria and "implicit support" in a securitisation context

Article 250 of the CRR prohibits implicit support given by an originator institution to the securitisation vehicle beyond any contractual obligations with a view to reducing actual or potential losses for investors when the institution has opted for not having to hold regulatory capital for the securitised exposures, to the extent permitted by the CRR. By prohibiting such actions, Article 250 of the CRR ensures that the credit institution does not become re-exposed to the credit risks that have been securitised.

The EBA clarified that the implementation of a general payment moratorium and certain listed actions of an originator or sponsor with respect to such a moratorium should not automatically constitute implicit support prohibited by Article 250 of the CRR, unless careful assessment of the situation leads to a different conclusion[12].

Even if general payment moratoria do not qualify as implicit support, they must nonetheless be notified to the competent authority.

II. Luxembourg State Guarantee Scheme

Among the legal tools aiming to limit the negative repercussions of the COVID-19 outbreak, the Luxembourg lawmaker adopted a law of 18 April 2020 implementing a guarantee scheme up to the aggregate amount of EUR 2.5 billion for certain credits granted until 31 December 2020 by Luxembourg banks to companies facing temporary financial difficulties (the “**April 2020 Law**”).[13]

In order to benefit from a State guarantee under the April 2020 Law, certain eligibility requirements must be met as further set out in (1) below. Eligible entities whose debt meet the criteria set out in the April 2020 Law will benefit from the State guarantee up to a certain cap (see (2) below).

1. Eligibility for the State guarantee scheme

The issuance of a State guarantee is subject to the fulfilment of two cumulative eligibility requirements, which relate to (a) the identity of the guaranteed borrower and (b) the characteristics of the guaranteed loan.

a. Guaranteed debtors

The April 2020 Law applies to any trade, craft, and industrial company holding a valid business licence (i.e. operating companies, to the exclusion of mere holding companies), as well as to any legal and natural persons who exercise professions listed in Article 91, paragraph 1, No. 1 of the law of 4 December 1967, as amended, regarding their income tax, such as doctors, architects, lawyers, journalists or translators. Cooperative companies in the agricultural and wine sectors are eligible, as well as start-ups.

Conversely, the State guarantee scheme is not available to companies, whose core business is the development, holding, rental and trading of real estate properties.

The debtor must have been financially viable on 18 March 2020, the date on which a state of emergency was declared.

b. Guaranteed loans

In order to be eligible for the State guarantee scheme, loans, credit lines, investment credits or overdraft facilities must be granted (i) by an authorised Luxembourg credit institution, (ii) for a maximum term of 6 years, (iii) between 18 March 2020 and 31 December 2020, and (iv) for the purpose of addressing temporary financial hardship following the outbreak of the COVID-19 pandemic.

It should also be noted that, even if a credit would as a matter of principle be eligible for the

State guarantee scheme, a bank may still refuse to grant it at its sole discretion, since this decision remains based on the commercial assessment of the borrower.

2. Cap on the State guarantee scheme

If any eligible loan, credit line, investment credit or overdraft facility is granted to an eligible entity or person for a maximum amount not exceeding 25% of their turnover for 2019, the State guarantee will cover up to 85% of the total amount lent to the borrower for the entire duration of the loan (the remaining 15% being borne by the participating bank[14]).

Conclusion

The diversity of measures taken by the Member States to address the unprecedented crisis caused by COVID-19 have given rise to a number of legal questions, particularly the interplay of such measures with the existing legal and regulatory framework.

The fact that the EBA has stepped in with the EBA Guidelines is welcomed, as it ensures that the regulatory treatment of moratoria will not put an undue strain on the EU credit institutions that have granted them. As was already learned from the 2009 crisis, the stability of the banking system is essential as it provides fresh funds in the economic cycle, allows businesses to pursue economic activities through the granting of credit and ensures that savings from the public in the form of bank deposits remain unaffected.

Although Luxembourg's prospects of recovery from the COVID-19 crisis are currently far from bleak, with two rating agencies recently confirming the country's "triple A" status, the impact of the crisis measures will have to be monitored closely in the coming months before such actions can be phased out or prolonged. Particularly, one of the key future dates is 24 December 2020, which will mark the resumption of mandatory filing for bankruptcy for traders and commercial companies.

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[1] It is also worth mentioning that both measures described herein are to be included in a

package provided by the Luxembourg Government in order to help commercial entities facing financial difficulties due to the COVID-19 crisis. For instance, the Law of 3 April 2020 (*Mémorial A,* No. 230 of 3 April 2020), as amended, introduced a new regime of aides for businesses encountering temporary financial difficulties. There is also a more recent law aimed at stimulating business investments in the COVID-19 era which was enacted on 24 July 2020 (*Mémorial A*, No. 640 of 24 July 2020), pursuant to which the Luxembourg State can grant investment aids to undertakings which meet the criteria defined therein. Such aids may be cumulated with the State guarantees granted by virtue of the law of 18 April 2020 establishing a guarantee regime in favour of the Luxembourg economy in the context of the COVID-19 pandemic (*Mémorial A,* No. 307 of 18 April 2020). To date, it is not yet possible to assess the popularity of the new legal tool introduced by the law of 24 July 2020.

[2] Circular CSSF 20/741 of 30 April 2020 adopting the Guidelines of the European Banking Authority on legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis (EBA/GL/2020/02).

[3] Law of 18 April 2020 establishing a guarantee regime in favour of the Luxembourg economy in the context of the COVID-19 pandemic (*Mémorial A,* No. 307 of 18 April 2020).

[4] Such as under suspension of payment, which is a type of insolvency proceeding defined in Articles 593 to 614 of the Luxembourg Commercial Code.

[5] A moratorium is not to be confused with the effects resulting from the application of a material adverse change (MAC) clause or a force majeure clause contained in the original agreement under which the debtor has to made certain payments to the creditor. The triggering of such clauses is automatic and does not require creditor consent before taking effect.

[6] Guidelines EBA/GL/2020/02 of 2 April 2020 on legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis, as amended by Guidelines EBA/GL/2020/08 of 25 June 2020.

[7] The participating banks are Banque de Luxembourg, ING, Banque Raiffeisen, BGL BNP Paribas, BCEE and BIL.

[8] EBA Guidelines, paragraph 13, which refers to EBA guidelines on the application of the

definition of default dated 28 September 2016 (EBA/GL/2016/07), paragraph 49.

[9] This deadline was initially set at 30 June 2020 under the original version of Circular CSSF 20/741 and was extended by Circular CSSF 20/749 to 30 September 2020.

[10] A moratorium application requested by a private individual can nevertheless be considered a general payment moratorium since the applicable conditions are standardised and available to all obligors affected by the COVID-19 pandemic.

[11] EBA statement on additional supervisory measures in the COVID-19 pandemic dated 22 April 2020.

[12] EBA Statement, paragraph 42.

[13] Law of 18 April 2020 establishing a guarantee regime in favour of the Luxembourg economy in the context of the COVID-19 pandemic (*Mémorial A,* No. 307 of 18 April 2020).

[14] The participating banks being Banque de Luxembourg, ING, Banque Raiffeisen, BGL BNP Paribas, BCEE, BIL, Bank of China and BCP.