KPMG SSM COVID-19 Insights

KPMG ECB Office alert

April 2020

This alert highlights the **most recent announcements and actions** of the ECB to support European banks during the current COVID-19 crisis:

The ECB's actions are twofold, impacting both monetary policy and supervisory activities.

ECB monetary policy measures from 3 April until 9 April:

On Tuesday 7 April, the ECB published some additional clarifications regarding a complementary package of temporary collateral easing measures to facilitate the availability of eligible collaterals with regard to liquidity providing operations (TLTRO III) which were previously announced.

It complements LTROs and PEPP for supporting the provision of bank lending, in particular, the ECB will:

– Adopt an unprecedented set of collateral measures to mitigate the tightening of financial conditions across the euro area;

– Temporary increase the Eurosystem's risk tolerance in order to support credit to the economy;

– Ease the conditions for the use of credit claims as collateral;

– Adopt a general reduction of collateral valuation haircuts;

– Restore the waiver to accept Greek sovereign debt instruments as collateral in Eurosystem credit operations; and

– Assess further measures to temporarily mitigate the effect on counterparties' collateral availability from rating downgrades.

ECB monetary policy measures published before 3 April:

– **Additional longer-term refinancing operations** (LTROs) to safeguard liquidity and money market conditions;

– **TLTRO III operation with considerably more favourable terms –** 25 basis points below the average rate applied in the Eurosystem's main refinancing operations - between June 2020 and June 2021;

– **€750 billion Pandemic Emergency Purchase Programme (PEPP)** of private and public sector securities;

– **A temporary envelope of additional net asset purchases of €120 billion** until the end of the year;

– No actions on interest rates; and

– **Prolong reinvestments of the principal payments** from maturing securities purchased under the **Asset Purchase Programme** for maintaining favourable liquidity conditions.

Source: More details from the ECB can be found here.

ECB supervisory activities published before 3 April:

– **IFRS 9**

- On Wednesday 1 April, the ECB sent to all significant institutions a letter regarding IFRS 9 in the context of the COVID-19 pandemic. The letter, with accompanying annex, seeks to clarify how the ECB would like to avoid excessive procyclical assumptions in IFRS 9 models to determine provisioning by expecting banks to use ECB staff's published macroeconomic forward looking information from March 2020 when estimating ECL given the current context of uncertainty. Furthermore, they expect banks to use informed judgement to update those projections to reflect lockdowns, severe social distancing restrictions imposed, public support measures as well as the potential rebound on the economy.

– **Dividends:**

- On Friday 27 March, ECB asked banks not to pay dividends until at least October 2020 in order to boost banks' capacity to absorb losses and support lending to households, small businesses and corporates. Banks should also refrain from share buy-backs aimed at remunerating shareholders.

– **The EU-wide stress test has been postponed to 2021,** allowing banks to focus on operational continuity, in line with the EBA's decision;

– **Temporary capital and liquidity relief:**

- The ECB has allowed banks to operate below the level of capital defined by P2G, the capital conservation buffer (CCB) and the liquidity coverage ratio.

- P2R can be met using Additional Tier 1 Capital (AT1) and Tier 2 (T2) capital instruments (anticipating the CRD V).

– Overall **supervisory activities planning is being re-scheduled**, meaning that on-site inspections (OSIs), remediation plans and even SREP could be delayed. Over the last weeks, ongoing OSIs have either been cancelled, or mitigating measures have been put in place such as working off-site to complete work. Furthermore, we are aware that the submission of NPL strategy, which was expected by end of March, has been delayed indefinitely.

Source: More details from the ECB can be found here.

Other supervisory actions impacting banks' regular activities in light of COVID-19 since 3 April:

Please click here for supervisory measures from the previous week

Date	Body	Further details
7 April	ESRB	Several jurisdictions have announced that they are reducing their countercyclical capital buffer (CCyB) rates. This is the case so far in Belgium, Denmark, France, Germany, Iceland, Ireland, Norway, Sweden and the United Kingdom (list of jurisdictions from the ESRB, last updated 7 April). More details can be found here.
3 April	BIS	The Basel Committee (BIS) and the International Organization of Securities Commissions announced that they have deferred the final implementation phases of the margin requirements for non-centrally cleared derivatives by one year. Additional information is provided in the press release.

Date	Body	Further details
3 April	BIS	The BIS set additional measures to alleviate the impact of COVID-19 on the global banking system. These measures support the provision of lending by banks to the real economy and provide additional operational capacity for banks and supervisors to respond to the immediate financial stability priorities. They complement the previous measures published by the Committee's oversight body, the Group of Central Bank Governors and Heads of Supervision. The document sets out technical guidance related to: (i) the exceptional measures introduced by governments and banks to alleviate the impact of the pandemic; and (ii) expected credit loss (ECL) accounting. The guidance seeks to ensure that banks reflect the risk-reducing effect of the exceptional measures when calculating their capital requirements. It also sets out the amended transitional arrangements for the regulatory capital treatment of ECL accounting, which will provide jurisdictions with greater flexibility in how to phase in the impact of ECL on regulatory capital. More information can be found here.

Topic specific points of view

1. **ICT and cyber risks**
2. **SSM banks' loan book post-COVID-19**
3. **The importance of stress testing in a pandemic climate**

ICT and cyber risks

As mentioned in our previous article, the ECB is closely monitoring the developments related to COVID-19 from an ICT and cyber risk angle. There have been extraordinary measures put in place by banks to keep operations going, such as extensive remote working which have in fact raised the threat of cyber-attacks and other ICT-related issues, and the ECB pre-empted this before many lock-downs took hold, raising two specific expectations in their letter dated March 3 to all significant institutions:

– Proactively assessing and testing the capacity of existing IT infrastructure, also in light of a potential increase of cyber-attacks and potential higher reliance on remote banking services;

– Assessing risks of increased cyber-security related fraud, aimed both to customers or to the institution via phishing mails

In this section, we explore the multidimensional threats that banks must be ready to face, be them **technical, external** or **internal**, and how banks can best take actions to meet these supervisory expectations in the face of the current context of the COVID-19 pandemic.

Technical threats

Since COVID-19 has been an unprecedented live test of banks abilities to work in a completely different manner (e.g. working remotely, shifting more services online, surges in data demands)

and cyber criminals may seek to exploit any failures in the maintenance of IT systems during the pandemic, banks more than ever need to assess whether they are in a position to guarantee at a minimum the following **technical measures** to ensure as strong an IT environment as possible:

– Ability to scale VPN, portals, and gateways to handle the sharp increase of personnel working remotely, and controls and limits in place for remote access to systems only for users requiring access and with only the access rights required to perform the remote intervention or work;

– Strong authentication mechanisms for remote access carried out via secured communication lines, depending on the sensitivity of information accessed;

– Ability to scale or prioritise capacity of critical ICT services in a safe and swift manner depending on performance and/or customer demand;

– Ability to quickly recover from a data centre failure and to manage dependency to key people in the crisis management chain of command;

– Availability of backups, and ability to keep them regularly tested to ensure they are not corrupted, and stored at a different off-site location; and

– Ensure all provided laptops have up-to-date anti-virus and firewall software, and patches are updated as usual. Maintenance should be logged appropriately.

External threats

Since the start of the pandemic, multiple supervisors have already warned the general public regarding the variety of cyber-attacks related to the pandemic that could occur, raising awareness of instances such as **phishing emails**, which attach malicious or macro-enabled Microsoft documents to exploit known Microsoft vulnerabilities or trigger the download of malware, which link to fake copies of legitimate websites in order to solicit users' credentials and passwords or other personal information (financial, taxes etc). Cybercriminals may also craft urgent emails pretending to be someone from the bank requiring the user to take an immediate action, such as processing an invoice, changing the beneficiary of a specific payment or convincing the user to reply with sensitive documents.

However, external threats are not limited to emails, and scammers or cyber criminals have already seized the opportunity to prey on consumers via **phone calls, texting, social media or fake news**. This includes but is not limited to phony customer advisories purporting to provide updates on service disruption due to COVID-19 and leading to malware downloads, or other scam or hoax text message campaigns that could prey on customer vulnerabilities in the name of the bank such as donations to charity, home testing kits, cures, health insurance or other fears.

To prevent risks arising from **external threats**, banks should consider the following:

– Continue to raise awareness amongst bank personnel regarding the increased likelihood of COVID-19-themed phishing attacks, how to identify them as well as providing remote workers with straightforward guidance on how to use remote working solutions safely (strong passwords with two-factor authentication for critical applications or ICT services) to protect against attacks at the source;

– Update the cybersecurity incident response plan with COVID-19 themed threats, describing how to react, including key contacts and the crisis management chain of command, and how to communicate with external entities such as external computer emergency teams (CERTs), governmental authorities, telecommunication etc.;

– Review measures to protect critical ICT systems from attacks either from the internet, extranet or intranet, such as perimeter defence technologies like firewalls, IPS/IDS, web application firewalls, web filters, mail filters, antivirus and content scanner devices; and

– Implement changes to procedures to prevent reoccurrence of any cyber-incident, such as security information and event management (SIEM), intrusion detection solutions (IDS), event analysis and escalation procedures which should assist management in prioritising known and identifying new vulnerabilities.

Internal threats

As well as the increased risk of technical threats and external cyber-attacks, remote operating locations and relaxing of some regulations could present an opportunity for an increase in fraud risk internally at the bank. As an example, claims from customers for government assistance, and the need for banks to process the approving of funds in a rapid manner, may subject banks to further losses.

To prevent risks arising from **internal threats**, banks should consider the following:

– Evaluate major existing operations, controls, policies and to identify potential vulnerabilities and detect unusual behaviour; and

– Have processes in place that would require finance teams to confirm any requests for large payments during the coronavirus pandemic, which could help to guard against the increased risk of business email compromise and CEO frauds.

Banks are now in a tough position – on the one hand, meeting supervisory expectations to maintain strong business operations, and on the other hand mitigating ICT and cyber-related threats. Using the key points above will be the first step to developing their multidimensional response strategy to tackle the threats triggered by the COVID-19 pand emic.

For more information on this topic, please contact Pierre Guerineau.

SSM banks' loan book post-COVID-19

The temporary capital relief measures adopted recently by the ECB, together with the ECB's recommendation to stop dividend pay-outs, could ceteris paribus provide temporary additional funding of up to EUR 4.3 trillion – more than one quarter of total loans of SSM banks. Of course, in reality, the number will be smaller because banks need the capital for COVID-19 related increased in RWA. Nevertheless, it is important to consider the impact of these measures on SSM banks' loan book as well as their potential outcome.

To state the obvious, some of today's new COVID-19 loans will emerge as defaults and Non-Performing Loans (NPLs) in the future. A relaxation of loan origination standards for new COVID-19 loans might even contribute to higher NPL-ratios, though these may be absorbed to some extent by government guarantees.

Given the adverse impact on their loan books from COVID-19, SSM banks face difficult strategic decisions when allocating the capital relieved by the ECB's measures. Avoiding a shortfall of capital in the future requires a careful trade-off between COVID-19 risks of existing loans and expected default risks of new COVID-19 loans. This strategic decision is even more relevant given the fact that deleveraging the balance sheet is unlikely to be an option for increasing capital ratios going forward (in contrast to the times post the financial crisis).

The effectiveness of fiscal and governmental measures are crucial for banks' loan books as these support the transformation of credit into economic growth and hence contribute to sustainable NPL levels and profitable loan books. Coping with the economic impact of the current pandemic represents a colossal task for societies, EU governments, corporates and banks. It is still too early to assess the effectiveness of governmental and EU measures, not only for loan books and resulting NPL and CET1 ratios. Thinking ahead, the debt shock from COVID-19 may contribute to further consolidation in the EU banking sector; or in a more adverse scenario stress EU financial stability measures.

Without a doubt, the current lockdown measures are economically expensive and dealing with them will need a broad range of measures, time and discipline from major stakeholders to avoid banks' loan books to collapse.

For more information on this topic, please contact David Nicolaus.

The importance of stress testing in a pandemic climate

As a consequence of the COVID-19 outbreak and its spread since February, the global financial outlook has deeply worsened. The financial sector is currently facing one of its strongest tests to date, as an unexpectedly severe macroeconomic scenario has materialised, becoming de-facto the new baseline starting point for the COVID-19 'pandemic scenario'. Such changes have also been quickly reflected in supervisory and regulatory bodies´ decisions to postpone their stress test exercises. On 12 March, the EU-wide stress test from EBA and ECB was postponed to 2021, and on 20 March, the Bank of England (BOE) cancelled their 2020 tests. It is also interesting to note that NCAs are postponing their stress test exercises for the years to come. For example, a recent decision from BaFin and Bundesbank postponed the 2021 stress test for Less Significant Institutions to 2022.

It seems clear that previous assumptions do not withstand anymore and would therefore prove too unrealistic for testing the banking industry's resilience and more importantly, that there is still significant uncertainty on the future scenario to come. From an industry perspective, banks are currently questioning whether the likely upcoming recession will quickly invert already in 2020 (in a 'V' shape pattern) or if a slower recovery is to be expected (in a 'U' shape pattern), due to the longer spreading of the virus, critically impacting GDP, unemployment rates and industry insolvency rates in the long-term.

What should banks be doing now in this current climate in terms of stress testing?

Nevertheless, internal stress testing could significantly help banks understand and anticipate potential impacts on their business. Undoubtedly, this could present valuable support for identifying the most impacted sectors and potential concentration risks of individual banks, by generating sector-specific shocks; in this sense, vulnerability analyses should be a reliable tool for targeting the specific assessment of loans and obligors, underlying collaterals and/or guarantees and eventually reviewing aggregated impacts on RWA and provisions.

In order to estimate capital impacts, banks should stress their portfolios by designing and implementing realistic yet dynamic stress test models and scenarios. In particular, risk parameters such as, probability of default (PD) and loss given default (LGD) should be carefully used, as currently they do not fully represent the underlying risk, given that they are based on past historical time series; credit conversion factors (CCF) should consider realistic increases of credit lines drawn amounts. Overall, top-down adjustments on risk parameters should be expected and scenarios should timely reflect mitigating effects of country specific measures (e.g. government guarantees).

Traditional stress test approaches should therefore be enhanced, and focus should shift onto long-term risks. It should be taken into account that such pandemic events, even though very rare, were already expected at some point from the scientific community, and should not be considered a "black swan" anymore. Preliminary discussions among supervisors and regulators were already pointing in such a direction: the introduction of new exploratory scenarios to test liquidity risk and cross-sectoral impacts, similar to the ones used by BoE in 2019 for its climate-change stress test, was one of the EBA's proposals regarding the future EU-wide stress testing framework. Similar features should be incentivised and expected to be adopted by banks in the years to come.

For more information on this topic, please contact Niccolo Anatra.

Key links

Visit the ECB Office homepage for reports and articles on banking supervision under the Single Supervisory Mechanism (SSM).

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