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.

Monetary policy measures from 9 April until 24 April:

On Wednesday 15 April, the ECB issued a press release on the support to the measures taken by euro area macroprudential authorities to address the impact of the COVID-19 outbreak on the financial sector. The measures announced by national macroprudential authorities since 11 March 2020 will free up more than €20 billion of Common Equity Tier 1 capital held by euro area banks. They include releases or reductions of the countercyclical capital buffer, systemic risk buffer and buffers for other systemically important institutions. In addition, some authorities have postponed or since revoked earlier announced measures to avoid placing pressure on banks to accumulate capital buffers in a downturn. The ECB published also an overview of the macroprudential measures taken by euro area authorities and their impact on banks' regulatory capital.

On Wednesday 22 April, The Governing Council of the European Central Bank adopted temporary measures to mitigate the effect on collateral availability of possible rating downgrades resulting from the economic fallout from the pandemic. The decision complements the broader collateral easing package that was announced on 7 April 2020. These measures aim to ensure that banks have sufficient assets that they can mobilise as collateral with the Eurosystem to participate in the liquidity-providing operations and to continue providing funding to the euro area economy. Impacts are expected to vary from country to country, based on national discretions on collateral eligibility.

In particular to note:

– Marketable assets and issuers of these assets that met the minimum credit quality requirements for collateral eligibility on 7 April 2020 (BBB- for all assets, except asset-backed securities (ABSs)) will continue to be eligible in case of rating downgrades, as long as their rating remains at or above credit quality step 5 (CQS5, equivalent to a rating of BB) on the Eurosystem harmonised rating scale; and

– Currently eligible ABSs to which a rating threshold in the general framework of CQS2 applies (equivalent to a rating of A-) will be grandfathered as long as their rating remains at or above CQS4 (equivalent to a rating of BB+).

Click here for monetary policy measures published before 9 April.

Supervisory activities from 9 April until 24 April:

On Thursday 16 April, the ECB announced a temporary reduction in capital requirements for market risk, by allowing banks with Internal Models Approach to adjust the supervisory component of these requirements. With this decision, the ECB is responding to the extraordinary levels of volatility recorded in financial markets since the outbreak of COVID-19, as well as smoothing procyclicality.

Click **here** for supervisory activities published before 9 April.

Other regulatory and supervisory actions impacting banks' regular activities in light of COVID-19 since 9 April:

Date	Body	Further details
22 April	EBA	EBA provides further guidance on additional flexibility in relation to market risk, SREP, recovery planning, digital operational resilience and ICT risk and securitisation in the context of COVID-19 and calls for heightened attention to risks. More information here: https://eba.europa.eu/eba-provides-further-guidance-use-flexibility-relation-covid-19-and-calls-heightened-attention-risk.
17 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). More details, including the map with the updated information as of 17 April can be found here: https://www.esrb.europa.eu/national_policy/ccb/html/index.en.html.

Topic specific points of view

1. **Managing credit risk and capital procyclicality**
2. **Liquidity risk management: Battle for survival or strategic positioning?**
3. **Combating COVID-19 with resilience: The increased risk of fraud**

Managing credit risk and capital procyclicality

As the crisis continues banks and supervisors are shifting their focus to credit quality and loan impairments. The next priority for banks is to limit the procyclical effects of the crisis and avoid serious repercussions for the real economy. Secondary effects on credit risk capital are already being felt, threatening to hamper the industry's recovery and reduce the availability of credit.

Based on current rules and regulations, the crisis is expected to create a significant increase in credit risk-weighted assets (RWA) and provisioning levels in Europe according to IFRS over the course of the calendar year, especially starting from the second quarter of 2020. U.S. banks have reported record high provisions according to U.S. GAAP in the first quarter in 2020.

The good news is that supervisors and regulators are already taking a range of actions to provide additional guidance and reliefs (e.g. EBA's Guidelines on legislative and non-legislative moratoria on loan repayments, ECB's reliefs on NPLs covered by public guarantees, ECB letter related to IFRS9 in the context of the COVID-19, etc.) to manage procyclical effects on financial systems and the wider economy. This should support the industry with their activities and approaches, but much remains to be done by banks on credit processes, systems and internal models.

Click here for the full article.

For more information on this topic, please contact Niccolo Anatra and Allan Folly-Darlis.

Liquidity risk management: Battle for survival or strategic positioning?

During the first weeks of the COVID-19 crisis, the ECB focused on providing "immediate liquidity support to the euro area financial system" (ECB, 12 March 2020). Similarly, the FED and other central banks as well as national governments intervened, in order to support financial institutions. Such decisive action was required, as more and more sophisticated corporates started drawing on their credit lines in order to preserve liquidity. Hotel, automotive and aviation industries were amongst the first to be hit by the pandemic and therefore increased their demand for liquidity. Boeing "tapped the full amount of a $13.8bn loan arranged barely a month ago" (Financial Times, 11 March 2020).

With the corporates' increased demand for liquidity, financial institutions' liquidity buffers started melting down. Particularly, banks that are serving sophisticated corporates in respective industries quickly entered crisis mode. Additionally, several banks observed liquidity drains from collateral calls that were triggered by the increased market volatilities. Throughout the month of March, banks operated under their crisis governance with Contingency Funding Plans being activated by many institutions. Financial institutions, regulators and central banks have triggered actions aimed at restoring liquidity buffers.

While the spread of COVID-19 has slowed down in a number of European countries, and measures by central banks and governments are becoming effective to some extent, several banks have moved to business as usual governance in an unusual environment. The financial industry is shifting the focus from ad-hoc short-term actions to navigating through the crisis also in the medium and long-term.

Key areas for consideration remain:

– **Crisis scenarios and steering approach:** Banks need to adjust their scenario views to navigate the COVID-19 situation. Liquidity stress scenarios that have been used over the past years (idiosyncratic, market, combined stress) do not provide insights for the current crisis. Banks that have predominantly managed liquidity based on stress tests, are facing challenges in interpreting stress test results under the current stressed environment (i.e. stress test applied on top of an actual stress). Several banks will need to establish additional liquidity metrics that support liquidity management during times of stress. Further, the current crisis is not comparable to the economic downturn scenarios that many banks have defined as part of their regular liquidity stress tests. Particularly, the dynamics in drawdowns on credit lines as well as the extent of market volatilities seen during the pandemic typically not captured by banks' stress scenarios.

– **Methods and models:** Banks need to revise methods and models used for liquidity management. Liquidity stress models that have been established and parameterised based on experiences from the financial crisis of 2007-08 do not provide meaningful insight on the further liquidity development during the COVID crisis. Banks will need to back test and revise certain models (e.g. make credit line models more prudent). Furthermore, several banks are assessing ways to increase the flexibility of models in order to allow for ad-hoc re-calibration if needed during a specific crisis.

– **Contingency Funding Plans:** Banks need to significantly enhance their governance and their ex-ante analysis of potential contingency measures. While several banks activated their CFPs for the first time in years, the COVID-19 crisis revealed a lack of clear governance and escalation mechanisms. Most banks had prepared lists of generic contingency measures that could be used during such a crisis, however, hardly any bank was able to action based on this level of information. Several banks observed difficulties to update respective lists of contingency measures on an ad-hoc basis. Given this experience, banks intend to establish regular processes for reviewing and updating contingency measures on a more detailed level.

– **Reporting and analytics:** Banks need to improve content, readability, and frequency of their crisis reporting. Several European banks still rely on liquidity reporting that is limited by low frequency and considerable time lags. During the current crisis, several banks have faced challenges in providing the senior management as well as external stakeholders with timely information on the liquidity situation. Additionally, a number of banks identified a requirement to improve the readability of management information, both, during times of crisis as well as normal times.

As the world decisively fights the direct and indirect damage by COVID-19, banks are building strategic capabilities to navigate this – and the next – crisis in the long run.

For more information on this topic, please contact [Arvind Sarin](#).

Combating COVID-19 with resilience: The increased risk of fraud

As we noted in our previous alert, the unprecedented consequences of the COVID-19 crisis has created an environment of uncertainty and heightened risk ripe for fraudulent activity, be it from external sources such as cyber-criminals, or from internal sources at banks themselves. Crucially, the fast-paced changes that are coming about in banks' attempts to mitigate operational issues can mean that they become more vulnerable to such predatory behaviour. In this section, we touch upon issues that banks should be aware of, and what has been seen in the industry so far in the last weeks of the 'new normal'.

In times where banks are operating on less stable ground, for example via remote working, or at a time when regulators and supervisors may be focussing on other more-pressing issues, it should be expected that all institutions can expect an increase in fraud cases. Under the pressure of investors, lower revenues and higher provisioning due to decrease in credit quality could ramp up the threat of internal manipulation of financial and performance data, especially with the upcoming half year reporting in the next months. This type of internal fraud tends to occur at the higher levels of banks, and since the financial crisis of 2007/08 with increased litigation settlement payments in the billions for various financial manipulation, this could prove to be costly in the long run. This, combined with the fact that some activities from internal audit and ECB on-site inspections have been drastically reduced, mean that the temptation to overstate profits or understate losses, especially with more judgemental accounting applications such as IFRS 9, IAS 36 and IFRS 15 could be quite high.

On the operational side of banks, with the threat of furloughs, loss of income or job insecurity, bank staff could feel an increase in theft impulses, such as invoice, payroll and accounting fraud, misappropriation of assets and / or data theft. With some staff working remotely, and an environment in which some governance anti-fraud controls may be relaxed, banks should be aware that they have adequate oversight on key risks such as access risk, in particular around any processes that are manual in nature. Combined with the fact that banks are spreading their operations in order to remain open and accessible for the general economy, the increase in motives to commit fraud plus a less controlled environment could have major consequences for banks' internal processes going forward.

Finally, as touched on in our previous alert, the unprecedented government schemes in order to help businesses and private citizens to keep afloat, such as payment moratoria and mortgage holidays, that are both complex and variant from country to country, could result in a situation where claims are made by some clients or customers fraudulently, and due to a lack of oversight or pressure to get transactions finalised as quickly as possible, could result in losses for the banks in the future. There have never been quite so many different stimulus activities being passed as in the last weeks, and banks may not be operationally prepared to process all requests with the required due diligence.

Given the myriad of threats facing banks, not only in the fraud space, but also in their day-to-day operations, it is critical that banks review their processes and controls around key activities, such as financial reporting, entity-level controls and other controls that are focused on anti-fraud prevention. Identifying key personnel in charge of oversight on access risk and processing governmental schemes should be a priority and ensuring that internal audit as well as other internal controls are operating at least at a level where key fraud risks are mitigated. In addition, evidence of fraud or breaches such as on trading activity should not be dismissed; they could indicate a bigger problem or a larger weakness that have not been previously identified. Our list of questions that should be asked by banks to maintain operational resilience will go a long way at identifying problems and protecting the internal integrity of banks' internal reporting systems.

For more information on this topic, please contact Maureen Finglass

Key links

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

Contacts

Henning Dankenbring
Partner, Co-Head
KPMG-ECB Office

Daniel Quinten
Partner, Co-Head
KPMG-ECB Office

kpmg.com/socialmedia

KPMG International, 15 Canada Square, London, E14 5GL

Designed by CREATE CRT126118 | 200129