KPMG SSM COVID-19 Insights

KPMG ECB Office alert

April 2020

European Central Bank (ECB)

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 supervisory activities and monetary policies.

Supervisory activities from 27 March until 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 their judgement 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 asks 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. More information can be found here.

Supervisory activities published before 27 March:

– 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 have allowed banks to operate below the level of capital defined by P2G, the capital conservation buffer (CCB) and the liquidity coverage ratio. In addition, the ECB would welcome the relaxation of the countercyclical capital buffer (CCyB) by the national macroprudential authorities.

- 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.

Monetary policy measures published before 27 March:

- **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.

Supervisory actions impacting banks' regular activities in light of COVID-19 since 25 March:

Date	Body	Further details
2 April	ESMA	ESMA has updated its risk assessment to account for the impact of the COVID-19 pandemic. In light of the pandemic and its impact on the EU economy and financial markets, ESMA assesses the risks in its overall remit, the securities markets, infrastructures and in asset management as all very high for the time being. The same applies to liquidity and market risks, and they expect a rise in operational, credit, contagion and consumer risks. Read more here: shorturl.at/fgmr7
2 April	EBA	The EBA issued Guidelines on legislative and non-legislative moratoria on loan repayments applied in light of the COVID-19 pandemic. This clarifies the application of the definition of default and classification of forbearance in the context of the various measures took by the Member States. Read the statement here: https://cutt.ly/TtU6CEN
1 April	SRB	The SRB contacts banks via a letter (https://cutt.ly/TtU6Bie) in order to announce operational relief in the context of resolution planning. The SRB will postpone less urgent information of data request and is ready to adapt transition periods for the build-up of MREL, as well as to review MREL targets. The Liability Data Report, the Additional Liability Report and the MREL quarterly template must be provided by banks on due time. Further steps will be coordinated with the internal resolution teams.
1 April	SRB	Elke König explains the SRB's approach to the uncertainty and disruption caused to the Euro Area economy by the COVID-19 outbreak. Read the latest blog post here: https://cutt.ly/0tU69i9.
1 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 1 April). More details can be found here: https://cutt.ly/MtU63H3.

Supervisory actions impacting banks' regular activities in light of COVID-19 since 25 March:

Date	Body	Further details
31 March	EBA	EBA clarified its expectations in relation to dividend and remuneration policies additional clarity on measures following its call for flexibility in the prudential framework and supervisory approaches to support lending into the real economy. EBA provided additional guidance on how to use flexibility in supervisory reporting and recalled the necessary measures to prevent money laundering and terrorist financing. More information can be found here: https://cutt.ly/gtU64RB.
31 March	EBA	Statement on supervisory reporting and Pillar 3 disclosures in light of COVID-19 here: https://cutt.ly/qtU65Xz.
31 March	EBA	Statement on dividends distribution, share buybacks and variable remuneration here: https://cutt.ly/Ztlqwnc.
31 March	EBA	Statement on actions to mitigate financial crime risks in the COVID-19 pandemic here: https://cutt.ly/ptlqtFu.
27 March	BIS	The BIS announced a series of measures aiming at increasing operational capacity of banks and supervisors to respond to COVID-19 outbreak. In particular, the measures endorsed by the GHOS comprise the postponement of several Basel III standard implementation deadlines: • The implementation date of the **Basel III standards** finalised in December 2017 has been deferred by one year to 1 January 2023. The accompanying transitional arrangements for the output floor has also been extended by one year to 1 January 2028; • The implementation date of the **revised market risk framework** finalised in January 2019 has been deferred by one year to 1 January 2023; • The implementation date of the **revised Pillar 3 disclosure requirements** finalised in December 2018 has been deferred by one year to 1 January 2023. Click here for more information: https://cutt.ly/dtlqoWm.
25 March	EBA	Click here to view all EBA statements in relation to its response to COVID-19: https://cutt.ly/Ttlqf1x.

Topic specific points of view

1. **COVID-19 implications on credit quality**
2. **Business continuity and Operational Resilience**
3. **Recovery and Resolution**

COVID-19 implications on credit quality

As a result of the COVID-19 outbreak, the deteriorations of debtors' KPIs will most likely lead to re-rating and potential increase in probability of default (PD) for a significant number of debtors, affecting prudential capital ratios. Additionally, the industry is already facing challenges to reduce the flow of new NPEs, which will most likely increase especially for portfolio's segments most vulnerable (transport, hospitality, tourism, etc.). The stock of NPEs requires banks (and supervisors) more flexibility to ensure the continuity of their NPEs strategies (sales/securitizations), as investors and service providers of such sold loans may also face difficulties from the crisis. Eventually, the positive results achieved on NPE ratios across the banking sector could be partially overshadowed. Worse forward looking information would also lead to unexpected movements of the portfolio exposures from stage 1 to stage 2 in the upcoming months, with potentially massive implications, especially on the provisioning side, also in light of calendar provisioning.

Nevertheless, even though the overall impacts on the banking system will depend on the effectiveness of government programmes, banks should try to implement mitigating actions to the extent possible, to prevent the level of new distressed loans and default. As a first step, it is essential for banks to focus on sectors at risk and take pre-emptive measures to avoid entangling new NPEs resulting from the COVID-19 crisis into the existing NPE stocks. Focusing on the ability to operationally process NPE requests and strengthening arrears management within the bank should be prioritised. Banks are currently performing portfolio sensitivity assessments by performing targeted stress testing of their portfolios (by cluster of risks) based on ad-hoc 'COVID-19 scenarios'. This is to assess the resilience of different borrowers' segments and types of loans to the crisis. Enhancing banks IT systems and data collection processes, allowing for example, to flag COVID-19 impacted customers and facilities can also greatly help banks to cope with the side effects.

These actions have to be taken by considering interdependencies with the new Definition of Default and Forbearance treatments in the context of COVID-19 as well as the postponement of the publication and implementation of the final Guidelines on Loan Origination and Monitoring which will allow banks to focus on the urgent elements and prioritise their tasks. Furthermore, all of the considerations must further be aligned to IFRS 9 and ensuring that the guidance in letters sent by the ECB to banks in the Eurozone on what macroeconomic forward looking information should be included in the calculation of ECLs which should avoid excessive procyclical assumptions.

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

Business continuity and Operational Resilience

In his blog post published 27 March 2020, Andrea Enria, Chair of the Supervisory Board of the European Central Bank (ECB) stated in the context of the COVID-19 pandemic that "Unlike in the 2008 financial crisis, banks are not the source of the problem this time." To be part of the solution, banks are expected to **guarantee business continuity** in an environment marked by uncertainty and the rise of coronavirus-themed cyber-attacks.In preparation for this ambitious goal, on 3 March 2020 the ECB already sent a letter to all signification institutions in which they outlined their expectations to enhance preparedness and to minimise the potential adverse effects of the spread of COVID-19, many of which relate to IT continuity requirements.

So what are the **key implications** for banks which could affect their ability to maintain business continuity during the COVID-19 crisis?

1. On 24 March 2020, the Indian government made a decision to lockdown effectively the entire country for 21 days in order to slow the spread of the virus in India. This has serious implications for banks that use resources in India as part of their back-office processes (eg: cash operations, call centres help desks)

2. COVID-19 has also meant that banks are facing an increase of likelihood for an IT failure affecting technical infrastructures given changes in usual operating procedure, new risks arising from working remotely, and increased cyber-attacks such as phishing campaigns.

3. Given the widespread lockdowns on European and global basis, there has been a surge in demand from both customers and clients to access banks on a digital platform. Depending on how digital demand increases, banks may have to reduce either product offering or services in order to meet the operational resilience capacity.

4. Remote operating locations and relaxing of some regulations eg: allowing trading room activities to occur outside of the trading room to facilitate home office working, or the cessation of some on-site activities from internal and external auditors or supervisors could present an opportunity for an increase in fraud risk internally at the bank. Furthermore, clients and customers may attempt to claim government assistance in the lending space fraudulently in an environment where the rapid progression of the pandemic may lead to less of a general oversight.

In response to these implications above, IT Risk management functions and key personnel can consider the below **questions** they could ask themselves in order to best address these implications:

– Have you considered which are your critical functions and suppliers that you rely on for the key upcoming operational tasks (such as the production of financial reporting for Q1) and have you identified alternative solutions to these critical activities?

– Have you identified your key IT personnel, including information security teams or other key dependents for incident and problem response, who could fall ill due to quarantines in place or may be unable to fulfil their regular duties at full capacity? Is it clear who will furthermore take important decisions should the traditional hierarchy (eg: CIO, CISO) be unable to make the appropriate calls?

– Have you monitored digital usage from clients and customers, and can you scale to meet changing demand? If decisions must be made regarding discontinuing certain products or services in order to ensure digital capacity, can you make prioritisations on a dynamic basis?

– Have you evaluated your major existing operations, controls, policies and procedures when it comes to day-to-day information security management to identify potential vulnerabilities and detect unusual behaviour, given the extraordinary measures and relaxing of some regulations due to the COVID-19 crisis?

Considering the aforementioned implications and responses banks should also consider **collecting data and KPIs** that will be part of the lessons learnt and the continuous improvement process, for which supervisors could potentially ask in the aftermath of the COVID-19 pandemic. Cases of incidents, outages, disruption, unplanned downtime, unauthorised accesses should be formally documented. Such cases could include, amongst others, how many data breach security incidents occurred, what was the number of successful COVID-19 themed cyber-attacks as well as the associated costs (e.g. losses, resulting penalties or fees, expenses for response and recovery activities, staff hours, involvement of external experts)what was the overall unplanned downtime or unauthorised accesses to critical IT systems.

The COVID-19 pandemic is a wake-up call for banks to consider holistically their organisation and evaluate how their IT capabilities can help them to face extreme events, even the ones we all thought were unlikely to occur. Several supervisors, including the ECB, have acknowledged over the past years that a growing reliance of banking operations on IT platforms, digitalised product channels for banking services, outsourcing to third-party providers of IT-related tasks and functions, and communication networks makes banks vulnerable to a wide range of operational risks - but what the pandemic is showing us now is that the multi-dimensional response needed to achieve operational resilience (governance, adequacy and expertise of resources, business continuity planning, information security including cyber-security management, and third-party provider management) cannot be done without agile and coordinated IT capabilities at the core.

Click here for the full article.

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

Recovery and Resolution

The SRB is carefully monitoring the situation related to the COVID-19 outbreak in the Euro area jurisdictions and analysing the impacts on financial markets and banks (see here the recent letter sent to banks).

As a pragmatic first step, the SRB will postpone less urgent information of data request relating to the 2020 resolution planning cycle and is ready to adapt transition periods for the build-up of MREL, as well as to review MREL targets of banks due to the significant impact from the latest capital relief measures adopted by the ECB. On the other hand, the Liability Data Report, the Additional Liability Report and the MREL quarterly template have been qualified as essential and must be provided by banks on due time. The EBA goes into the same direction (see press release) by considering that reporting for resolution planning purposes (especially information on institution's liabilities structure) are fundamental and must be provided in the applicable reporting standard even in the current climate.

As per industry insights, KPMG professionals have also seen calls for further reliefs in the context of resolution planning:

– Extension of the deadlines especially for the resolution reporting packages (also due to XBRL-Format and the involvement of IT functions) but also for all measures in the context of the achievements of resolvability (e.g. self-assessment report and dry-runs);

– Stability of reporting contents and formats for 2021 (especially Liability Data Report);

– Suspension/reduction of the contribution to the Single Resolution Fund for this year in order to reduce impact on banks' P&L.

Further steps will be coordinated in close cooperation with the internal resolution teams (IRTs) which are mandated to adjust the individual bank's work program if substantiated requests are being made.

Based on ECB press release dated 12 March 2020, the industry expects operational relief in the context of recovery planning in 2020, although no official statement by the ECB has covered this topic yet. On a high level, one could expect at least the introduction of a COVID19/ pandemic system wide scenario. Further communication in this space from the ECB will be highly appreciated by the industry.

It is clear that during times of crises, a well-performing and robust crisis management and resolution framework is of great importance. This is supported by the fact that ECB and national authorities audit the feasibility of crisis management frameworks in the current crisis by real time dry runs. In the current COVID-19 crisis the overlap of operational resilience to recovery and resolution planning becomes even more visible. A momentum for the regulatory developments concerning operational resilience is expected and authorities in the Banking Union might have a closer look at lessons learnt from existing UK regulations in that context.

For more information on this topic, please contact Kristina Brixius and Allan Folly-Darlis.

Key links

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

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