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KPMG SSM COVID-19 Insights

KPMG ECB Office alert

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European Central Bank (ECB)

This alert highlights the **most recent regulatory and supervisory actions** impacting banks' regular activities in light of COVID-19.

This alert includes three topic specific points of view:

1. **Recovery planning during COVID-19**
2. **Fighting money laundering and terrorist financing**
3. **Implications for credit risk modelling**

Latest regulatory and supervisory activity:

ECB
Click here for the latest ECB measures. This also includes the latest updates to SREP 2020, as announced 13 May.

EBA
Click here for the latest EBA measures in response to COVID-19.

Recovery planning during COVID-19

The unprecedented COVID-19 crisis has brought about many challenges for the financial sector, and regulators and supervisors continue in their efforts to ensure banks can focus on core operations and effective crisis management and preparedness. A key element here to are **recovery plans**, which aim at restoring banks' financial and economic viability under stress. Following the ECB's announcement on 12 March of temporary capital and operational relief in response to the pandemic, the EBA published a series of expectations on 22 April, which clearly indicate to banks that alongside monitoring all their recovery indicators, they must enhance their focus on understanding which recovery options are necessary and available under the current stressed conditions. The message is clear: information on recovery planning can quickly become outdated and time is of the essence for prompt reporting to competent authorities. It is also the banks' intrinsic interest in having up-to-date KPIs and KRIs for effective bank management.

Regulators and supervisors have recently published expectations for recovery planning. This includes monitoring and reporting obligations in times of stress. In our article we discuss what this means for banks and how best to respond.

Click here to read the full article.

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

Fighting money laundering and terrorist financing

The recent increase in COVID-19 related crimes is a strong reminder that criminals and terrorists may seek to exploit all possible avenues including temporary weaknesses in Anti-Money Laundering (AML) and Counter Financing of Terrorism (CFT) controls and systems created by the pandemic. Last week FATF (Financial Action Task Force), a global money-laundering and terror financing (ML/TF) watchdog, warned that the pandemic has opened the door to new criminal scams and laundering opportunities – including illicit entities bypassing customer scrutiny as financial institutions focus more on giving out emergency stimulus loans to keep the world economy afloat. The EBA also reiterated the importance of effective systems and controls measures to prevent ML/TF and asked competent authorities to support financial institutions' ongoing efforts by sharing information on emerging ML/TF risks, setting clear regulatory expectations and using supervisory tools flexibly.

Further, the experience of recent high-profile scandals shows that AML and CFT efforts can all too easily be weakened by a lack of cross-border co-ordination. As a result, European authorities have launched several major initiatives intended to strengthen the EU framework for AML and CFT. One of the prominent initiatives included the European legislature empowering the EBA to lead, coordinate and monitor EU supervisors' fight against ML/TF. Subsequently, on 5 February 2020, the EBA published its first report on competent authorities' approaches to the AML/CFT supervision of banks.

This report made several findings such as:

– to move from 'tick box' compliance to a more qualitative assessment of AML/CFT controls;

– to take a more proportionate approach to correcting deficiencies in AML/CFT systems; and

– to cooperate better with national and EU supervisors and other stakeholders.

In addition, on 7 May 2020, the European Commission launched a public consultation on it's a six pillars action plan, which sets out concrete measures that the Commission will take over the next 12 months to better enforce, supervise and coordinate the EU's rules on combating ML/TF.

The six pillars of this action plan include:

– Effective implementation of existing EU rules;

– A single EU rulebook;

– EU-level supervision;

– A support and cooperation mechanism for member state financial intelligence units;

– Better use of information to enforce criminal law; and

– A stronger EU in the world.

In light of these recent initiatives, it is evident that supervisors and regulatory authorities will significantly increase the scrutiny of matters concerning ML/TF in the near future (driven by SREP). It is therefore critical for financial institutions to deploy stringent measures in order to circumvent emerging risks related to ML/TF. Against the aforementioned background, we recommend that banks should consider taking the following measures in order to mitigate AML and CFT related risks:

– Use of a risk-based approach to customer due diligence (CDD);

– Increase usage of digital systems for Know Your Customer (KYC) and other ongoing data checks;

– Implement solutions to perform remote customer verifications specifically in the situation of changes to work practices put in place to allow for social distancing;

– Adjust transaction monitoring systems to avoid generating alerts on customers due to change in their activities. For instance, a customer activity may have dropped due to ongoing situation related to pandemic –such as "stay at home" order;

- Implement AI and Machine learning solutions to effectively detect suspicious transactions or abnormal patterns in order to reduce the number of false positives alerts, thereby reducing the workload of AML/CFT compliance teams;
- Deploy adequate measures to update and track changes to the AML/CFT detection models due to change in consumer behaviour as a side- effect of the pandemic;
- Establish framework to assess the firm wide impact of COVID-19 on AML/CFT risks and systems specifically at the product or business unit level;
- Develop a plan to deal with the aftermath of COVID-19 focusing on aspects related to AML/CFT business continuity; and
- Continue to maintain positive AML/CFT culture within the firm by periodically providing trainings to employees on emerging ML/TF risks.

In summary, banks should closely track regulatory and supervisory initiatives as well as assess the pandemic's implications for AML/CFT compliance to circumvent potential financial and reputational consequences in future for their action now.

For more information on this topic, please contact Girija Chandrawat.

Implications for credit risk modelling

Since the outbreak of the crisis, many EU member states have imposed lockdowns. They are associated with substantial macro-economic implications. Even though countries have taken mitigating actions, bank loan portfolios are starting to deteriorate. The number of downgrades has significantly increased. We expect that banks are required to revisit credit risk internal models, Pillar I – IRB models as well as models used for the Internal Capital Adequacy Assessment Processes (ICAAP) or for IFRS 9 purposes. Additionally, considering that future implications of current state aid measures such as moratoria are still not clear as they strongly dependent on future economic growth, banks could be required to further recalibrate their models and outputs.

Focus on credit risk models´ inputs

Regarding banks´ credit risk models, a first general consideration would be that COVID-19 effects on real economy have just started to materialise and therefore might not fully reflect into obligors´ financial information, due to reporting inherent time lags. Even though IRB models are typically Through the Cycle (TTC) or Point in Time (PIT) hybrid in nature due to CRR requirements, behavioral components, market data input, pre-crisis financial input data and the like may overestimate or underestimate the real riskiness of obligors without overrides or model adjustments. Adding up the several payment moratoria and exceptional forbearance measures not automatically leading to default which obligors may request, it is clear that the current data should be carefully assessed. To overcome these issues, banks might focus on trying to reduce models´ dependencies on the macroeconomic cycle, towards a more TTC rating philosophy (especially for non-regulatory credit risk models), and try to better depict the evolution of obligors´ financial data through projections to be used into models´ components.

Banks need to have appropriate projections, based on realistic expected scenarios. Banks simulation framework is of high importance to properly assess economic developments and related portfolio implications. A top-down simulation approach could help identifying portfolio credit risk parameters´ (PDs, LGDs, CCFs) evolution at different levels (e.g. industry, economic sector and/or country level), by using the stress testing framework and enhancing it with level-specific risk differentiation. Whereas, bottom-up approaches would allow banks to project rating systems´ input to be eventually fed to internal models and provide more tailored results. The choice, if it has to be made, should carefully consider underlying costs and effort (also time implications).

Focus on credit risk models´ outputs

In order to properly analyse the change in risks of loan portfolios in this crisis scenario, banks should adapt and adjust their credit risk models´ outputs for both credit management and prudential purposes.

As IRB models in place might not be able to reflect obligors´ riskiness due to the current economic conditions, a sensible amount of rating overrides are to be expected. The changes in the COVID-19 crisis have made quick updates to ratings of existing obligors as well as initial ratings for new clients necessary; additionally, in many cases the rating process is accompanied by manual steps and judgement by credit analysts, who are under increasing operational pressure. In order to cope with the rapidly evolving situation, banks should try to introduce risk-related simplifications in credit granting and rating assignment processes when possible. This could be done by using adequate process decision trees to identify situations where a simplified process might be sufficient.

While banks could opt for a comprehensive re-rating of all portfolios, a more targeted approach could be carried out, specifically for the corporate one: apart from triggering the re-rating process upon a borrower request (e.g. credit line extension, payment moratoria, etc.), a top-down assessment at portfolio level based on either sector analysis or data-driven dependency analysis could be performed. In any case, as CRR still applies and both regulators as well as supervisors expect portfolio risk assessments to continue. Risk reporting needs to be up to date. Thus, banks should identify the most efficient approach, especially considering potential implications on day-to-day operational continuity.

Additionally, state aid measures could also have a critical impact on credit risk internal model outputs, particularly for IFRS 9 provisioning purposes. In addition to delaying inception of potential defaults as it is likely that at least some obligors benefiting from payment moratoria will default in the near future, they will change obligors´ operating cash flow structure. Moreover, the implications of the crisis on the quality of banks´ collateral portfolio have to be assessed as it could potentially impact LGD. Several options should be considered, ranging from systematic re-valuation over ad-hoc re-valuation to more top-down driven assessments; impacts on credit provisioning are to be expected.

Regarding prudential adjustments, adequate estimators for LGD and CCF downturn components must be used: the current prudential framework treats them as independent of the macroeconomic conditions, despite a downturn period. It should be considered also that the EBA expects banks to use dynamic downturn adjustments. Finally, in case significant changes in time series, representativeness, processes and data will materialise, the margin of conservatism (MoC) adjustments might be updated, in line with EBA guidelines.

To summarise:

– Banks should review credit risk models´ inputs, to ensure that the relevant risk drivers are properly considered and information on their evolution are timely fed to their risk models.

– Banks should carefully assess credit risk models´ outputs, both from a credit and prudential point of view, as risk parameters (PD, LGD and CCF) should adequately reflect the changes of obligors´ riskiness and prevent an excessive risk taking.

– We recommend to appropriately document any decisions, top down adjustments and other changes implemented in response to these turbulent times – they might be challenged by supervisors and other authorities in the future.

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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