# KPMG SSM COVID-19 Insights

## KPMG ECB Office alert

**April 2020**

This alert highlights the most recent regulatory and supervisory actions impacting banks' regular activities in light of COVID-19 since 30 April.

This alert also includes three topic specific points of view:

1. **Resolution planning**
2. **How payment moratoria affects the non-financial risk profile of banks**
3. **Market risk**

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### Regulatory and supervisory actions impacting banks' regular activities in light of COVID-19 since 30 April:

| Date | Body | Further details |
|---|---|---|
| 30 April | EBA | The EBA have a dedicated webpage for all latest measures and their response to COVID-19.<br><br>For more information visit: https://eba.europa.eu/coronavirus |
| 30 April | ECB | The ECB have a dedicated webpage with all the banking supervision and monetary policy measures put in place to mitigate the impact of COVID-19 on the euro area economy.<br><br>For more information visit:<br>https://www.bankingsupervision.europa.eu/home/search/coronavirus/html/index.en.html |
| 28 April | European Commission | The European Commission has adopted a comprehensive banking package for supporting banks´ lending.<br><br>It includes clarifications on:<br><br>– IFRS9: SICR, use of loan guarantees and ECL provisioning;<br>– Payment moratoria: impacts on SICR, forbearance and definition of default;<br>– Definition of Default: use of guarantees.<br><br>It also includes proposed amendments to the CRR, regarding IFRS9 transitional arrangements and temporary treatment of public guarantees.<br><br>For more information visit:<br>https://ec.europa.eu/info/publications/200428-banking-package-communication_en |

## Resolution planning

The implications of COVID-19 continue to grow for banks globally, and the additional workload of maintaining operational continuity has pushed banks to reprioritise their project work in the context of resolution planning. Moreover, in Europe we see banks struggling to build up MREL as per the requirements recently set, in particular from the Single Resolution Board (SRB) under its MREL policy. In a recent blog post from Elke König, Chair of the SRB, the SRB's response to the COVID-19 crisis is summarised, reiterating their commitment to supporting the steps already taken by the ECB, the SSM and national competent authorities to help banks deliver their services to the real economy, and in particular to keep lending. In this article, we discuss recent publications that clarify the SRB's expectations for banks regarding resolution planning and MREL, challenges that banks must now face, and what the SRB has so far communicated to banks regarding their response to the impacts of the pandemic in the context of the above topics and how they are working closely with banks to mitigate these effects.

Click here to read the full article.

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

## How payment moratoria affects the non-financial risk profile of banks

One of the most common economic measures being used during the current COVID-19 crisis is moratoria for payments of credit obligations. They allow for suspension or postponement of payments for a certain period of time. Moratoria are aiming to provide relief to the real economy given deteriorations in income.

As the specifics of payment moratoria differ across jurisdictions, this measure raises questions for banks' risk management systems and processes. Although the EBA has provided guidelines on moratoria on loan repayments to be applied in light of the COVID-19 crisis on 2 April, questions remain in our view as specific legal guidance on how to apply COVID-19 moratoria in practice are generally lacking. As a result, banks are facing non-financial risks (more specifically - legal and reputational risks) from deciding who should benefit from payment moratoria to which extent.

When considering the implications of payment moratoria on banks' risk profile, granting moratoria to clients without a clear post-COVID-19 perspective increases banks' credit risk (particularly due to an increase in LGD). On the one hand, and seen from an operational risk perspective, this could result in board members being sued by shareholders for destroying shareholder value due to gross negligence in the aftermath of the crisis. On the other hand, not granting moratoria to clients could cause lawsuits by those affected clients and/or reputational risk if stakeholder's expectations are not sufficiently met. Coping with large numbers of payment moratoria therefore might challenge banks' non-financial risk management systems and require further attention.

In our view, the appropriate approach depends on various factors that determine the specific non-financial risks arising from payment moratoria due to COVID-19:

– **Risk strategy/appetite** determines (among others) a bank's appetite for legal and operational risks and provides a comprehensive framework for monitoring and limiting them;

– **Legal environment** e.g. legal enforceability of payment moratoria, presence of activist shareholders or burden of proof;

– **Structure and nature of the client base** as some clients are more affected by COVID-19, resulting in more payment moratoria being granted by some banks compared to others; and

– **Market competition** which contributes to more payment moratoria for clients to avoid a loss of clients / customer churn and hence a loss of future business.

For addressing these factors and dealing with how best to overcome the challenges from COVID-19 triggered payment moratoria, we recommend the following:

– Banks should analyse their specific situation regarding the abovementioned factors and then develop a clear strategy, process and internal guidelines, based on an objective criteria which includes how to deal with payment moratoria due to COVID-19;

– The decision support outlined in the process should follow a well-defined risk strategy/appetite for all material risks such as credit risk, operational risk and reputational and potentially other risks;

– Banks should consider receiving approval by the Supervisory Board or similar bodies as this could mitigate the personal liability (i. e. legal risk) of the Executive Board members to some degree;

– Banks should be transparent about the process. Communicating it proactively to all relevant stakeholders (including, but not limited to, customers) to help mitigate reputational risk; and

– Last, but not least, sufficient resources (financially and employee-wise) should be made available to deal with materialising risks from payment moratoria (across the spectrum of financial and non-financial risks).

As a conclusion, we consider it essential for banks to develop a tailor-made approach with buy-in from all involved stakeholders to cope with COVID-19-triggered payment moratoria instead of a purely ad-hoc driven approach. The latter is likely to be harmful for banks in the aftermath to the crisis as it will contribute to increased levels of non-financial risks.

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

### Market risk

The COVID-19 pandemic has significantly affected financial markets in the first quarter of 2020. Stock markets have dropped abruptly and volatility has increased. Treasury bond yields have reached record lows and credit-default-swap indices have been surging, reflecting concerns of increased corporate defaults. For many assets and liabilities, fair values have changed significantly, reflecting changes in cash flow forecasts, higher uncertainty and elevated risks. Extreme volatility throughout financial markets has affected multiple asset classes, which has generated exceptional increases in asset price dispersion and widening of bid-offer spreads.

Consequently, market risk limit breaches were observed, value-at-risk (VaR) figures and thus capital requirements / RWAs for banks with internal models increased. At the same time, back-testing exceptions escalated this effect as they increase the bank specific scaling factor for the market risk capital figures. Thus, current market turmoil triggers a procyclical increase of market risk RWAs.

Not only had the risk capital demand increased, also available capital suffered from losses as well as increases in capital deductions such as Prudent Valuation Adjustments. The market turbulences stressed both the nominator and denominator of the capital adequacy ratios.

Supervisory countermeasures to mitigate the adverse effects on market risk capital requirements differ across jurisdictions. For example, The Bank of England (BOE) will allow firms to offset increases due to COVID-19 related back-testing outliers through a commensurate reduction in risks-not-in-VAR (RNIV) capital requirements, while in Switzerland the number of back-testing exceptions are frozen at the level of 1 February 2020 until 1 July 2020.

The ECB has timely announced (on 12 of March) unique temporary relief since the outbreak, allowing banks to use the capital buffers in order to boost funds for lending to businesses and retail clients. This buffer utilization freed up 120 billion euros of capital and subordinated debt. Regarding market risk, the ECB announced on 16 April that the bank specific qualitative market multiplier would be temporarily reduced. Generally, the multiplier is set by the supervisor and depends on the quality of the internal model (the better the lower). The reduction aims to offset adverse effects of back-testing outliers and to keep the overall multiplier stable, like the Swiss approach.

To further mitigate the impact of exceptional volatility triggered by the pandemic on the prudential requirements for market risk, and thus on bank's loss absorbing capital, the EBA proposed to adjust its standards on prudent valuation by increasing the diversification factor used to calculate additional valuation adjustments (AVAs) for Market Price Uncertainty (MPU), Close-out-Costs (COC) and Model risk from 50% to 66%. It estimates that this adjustment will mitigate the excessive pro-cyclical effect of the current PruVal framework by 20% to 30%.

Furthermore, acknowledging the increased operational challenges faced by banks in the area of reporting, the EBA also intends to delay the reporting for the first FRTB-SA figures to September 2021.

#### KPMG perspective

The recently published measures of the ECB allow lower capital requirements when calculating how much capital banks must set aside for market risks. Banks with internal market risk models will benefit. The magnitude depends on bank´s position, model quality, etc. The mechanics of setting the quantitative multiplier are prescribed in the CRR whereas the supervisor specifies at its own discretion the qualitative multiplier. Only the latter could be chosen to implement a mitigation of pro-cyclical capital effects. Given the fact that the potential for capital relief depends on the value of the qualitative multiplier it becomes clear that this is more beneficial for banks with less advanced internal models which operate under higher qualitative multipliers.

For more information on this topic, please contact Matthias Peter and Sofia Pignatelli.

## Key links

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

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