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 four topic specific points of view:

1. **IFRS 9 bank disclosures**
2. **A supervisory view of IT and cyber risks since the outbreak of COVID-19**
3. **Fair Value Measurement**
4. **SREP 2020 pragmatic approach**

IFRS 9 bank disclosures

As we move towards half year reporting, most European banks will be working towards writing their disclosures which will inevitably include the impact of the COVID-19 pandemic especially on their loan books. The ECB in their letter to banks of supervisory expectations regarding IFRS 9 confirmed that they will be publishing their macroeconomic projections for the euro area on 4 June 2020, meaning these should be taken into account for their reporting as of the end of the month. However, when it came to first quarter reporting, the full extent of the impact on credit loss was largely unknown, and the resulting financial disclosures for the quarter highlighted the uniqueness of the situation with varying approaches to quantifying the impact disclosed in varying level of detail.

Along with an analysis in KPMG's IFRS recent blog, the KPMG ECB office has looked at a sample of Significant Institutions' disclosures in order to understand the differences in level of detail of disclosure, and analyse the different ways in which some banks have approached their first quarter reporting.

What have we seen so far?

In terms of level of detail, the first thing to note is that reporting requirements differ for the first and third quarters between banks depending on the listing country, and generally range from stock exchange announcements to full interim financial statements prepared according to IAS 34 and reviewed by the company auditor. As a result, the disclosure of the impact of COVID-19 on the credit loss for the period varied significantly.

As expected, loan provisioning in Q1 increased for all banks, and most banks furthermore specified the direct impact of the pandemic on the numbers. On average for the sample we looked at, this was 47% of the provision amount directly attributable to the crisis, with lows of 31% attributable and highs of 78% attributable.

Primarily, we noted that banks in our sample utilised a management overlay or top level adjustment on top of the output of the IFRS 9 models for the quarter. Banks used this method when the impact to the macroeconomic inputs in the IFRS 9 models were not yet reflecting the forecast economic downturn of the pandemic as well as the resulting governmental assistance measures. These overlays were calculated by either calculating the impact of the updated macroeconomic outlook due to COVID-19 or by reviewing specific sector or individual exposures to the impact of COVID-19.

In terms of sectors impacted by the crisis, this varied between banks, but some key sectors appeared across multiple banks. As expected, these included tourism, hotels and catering (two thirds of our sample), aviation (just under two thirds), transport shipping and supply chain and non-food retail (around half of our sample).

Amongst the banks, the general trend in forecasts anticipated declines in 2020 with recovery in 2021. However, the degree to which the decline and recovery would occur varied widely amongst the banks. Some banks had a more optimistic view, identifying a range in the decline in 2020 for the Eurozone between 4.2 – 7.5%, with some being ranges larger at 11.3% or even 13%.

Furthermore, around half of our sample disclosed the EBA and other regulatory and supervisory guidance on forbearance and default in light of payment moratoria or noted that, in line with guidance, automatic transfers between stages had not occurred. In addition, a few banks edited their forward looking information disclaimer specifically in light of COVID-19 to highlight the uncertainty.

Next steps

As banks head towards the end of the second quarter and the resulting preparation of their interim financial statements under IAS 34, disclosures around IFRS 9 will be under focus. Both regulators and supervisors have highlighted in the last months that transparency in the impact and adjustments for the COVID-19 crisis will be key for interim reporting. In this light, banks should take the recommendations of the European Securities and Market Authority (ESMA) into consideration when preparing their half year reporting i.e:

- Keeping the objective of providing timely, relevant and reliable disclosure within the time allowed by national law for listed issuers to prepare their financial reports without undue delay. This should include the impact of any material events occurring after the end of the reporting period and providing any relevant disclosures;

- As interim financial statements under IAS 34 should update any new activities, events or circumstances since the year-end disclosure, there should be an expectation of extensive disclosure for the half year, given the impacts of COVID-19, particularly in relation to significant uncertainties and risks, going concern, impairment of non-financial assets and presentation in the statement of profit or loss;

- Recommended transparency around the application of relief and support measures, and any underlying judgements that come from them; and

- Including entity-specific information on the impact of COVID-19 on both past and forecast strategic orientation and targets, operations, performance of issuers as well as any mitigating actions put in place to address the effects of the pandemic.

For more information on this topic, please contact Maureen Finglass and Phoebe Aroney Tulloch.

A supervisory view of IT and cyber risks since the outbreak of COVID-19

Taking a step back to look at ICT and cyber risks in the context of COVID-19: where are banks now as we move into the new normal?

How have supervisors positioned themselves in reaction to the pandemic and how are they assessing banks' actions so far?

Prior to the COVID-19 pandemic, the positioning of the ECB when it came to ICT and cyber risks was clear: they were a key priority. The 2020 SSM risk map identified cybercrime and IT deficiencies as one of the top three risks faced by the euro area banking system. The SSM cyber incident reporting framework has ensured that all directly supervised banks report significant cyber incidents to the ECB as soon as they are detected. For example, in 2019 phishing attacks were the most frequently reported type of incident, followed by distributed denial of service attacks (deliberately overwhelming systems with requests) and accidental data leakages.

So, it is no surprise that many of the ECB expectations in reaction to the pandemic were closely related to IT continuity and cyber risk awareness, and we explored that in our article at the beginning of the pandemic. Since one of the main aims of the supervisory response during the outset of many lockdowns was to support banks' focus on key operations and to alleviate operational challenges banks were facing, a number of measures were introduced to mitigate them. However, supervisors have also stepped up their monitoring of banks' orderly operations and called on institutions to review their business continuity plans in the context of COVID-19 with a specific focus on banks' operational resilience and ICT infrastructure.

With these priorities and measures in mind, and at the time of a gradual reopening of European economies as well as measures aimed at easing lockdown conditions, how are supervisors assessing banks' actions so far?

The EBA Thematic note "The EU banking sector: first insights into the COVID-19 impacts" published on 25 May 2020 notes that so far banks did in fact manage to contain the impact of the crisis on their operations, and despite the fact that many operations and business continuity were put under strain, banks' critical functions continued to operate, meaning that past efforts to develop business continuity plans have proved to be a worthwhile undertaking. The note goes on to state that they were unaware of any major incident of business disruption attributable to the crisis. However, the note still acknowledges that the crisis has left banks more vulnerable to cyber-attacks and ICT-related risks. Most incidences of cyber-attack attempts and disruptions reported were mostly targeted directly at customers or ICT infrastructure providers rather than at the banks themselves.

Click here to read the full article and find out what the short-term implications are for banks from a business and regulatory perspective, along with insight on what the supervisors will focus on as the pandemic develops.

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

Fair Value Measurement

The COVID-19 pandemic and subsequent uncertainty surrounding both its severity and potential duration continues to present multiple challenges for banks. For those banks that report fair values for complex and illiquid financial instruments, the ongoing market disruption adds another layer of complexity when it comes to the matter of appropriate valuation and disclosure. As the name implies, fair value measurement is a market-based measurement: assumptions should be used that market participants would use, reflecting market conditions as of the measurement date, without the use of hindsight of adjusting for depressed pricing. Since this measurement is based upon assumptions and inputs, any period of financial disruptions presents challenges for banks, to ensure that their fair value measurements accurately reflect current market conditions, and it can be assume that the fair value of assets and liabilities will have changed significantly.

In this section we explore a short summary of current market developments that we have noted in the industry, how they affect various products, and what impact this might have on banks under the current supervisory landscape.

Current Market Developments

Volatility in prices in the markets can affect fair values essentially in two main ways, either direct (e.g. if fair value is determined based on market prices such as debt securities traded on the active market), or indirectly if valuation is performed using inputs derived from volatile markets.

For this reason, the main observations from our KPMG iRADAR valuation group that are affecting fair value are:

- Decrease in market liquidity;
- Number of quotations decreased since December, particularly for credit instruments;
- Less consistency in pricing feeds from established pricing services;
- Bid/Offer spreads increased in all markets;
- The basis between bonds' and CDS spreads have reached end of March twice to three times the levels as of end of December 2019.
- Credit spreads for investment grade and non-investment grade entities increased;
- Structured finance assets' discount margins have doubled driven both by credit and liquidity changes;
- Equity volatility reached levels of the last financial crisis;

– Interest rates implied volatilities have spiked; and

– Companies have cancelled or postponed dividend payments.

Such developments impact the markets in different ways, as summarised below.

	Fixed Income	Interest Rate	FX	Equity	Credit
Decrease of Market liquidity	✓	✓	✓		✓
Increase in Credit Risk	✓				✓
Increase of Market volatility	✓	✓	✓	✓	✓
Cancellation of dividends				✓	

Source: KPMG International

Impact on banks in current supervisory landscape

As we have noted previously, supervisors have over the last years increased their attention on the topic of fair value measurement, and via on-site inspections (OSIs) have focused from the inception of transactions (including new product approvals, the effectiveness of controls and governance over policies in the valuation framework), the Independent Price Verification (IPV) process right up until fair value hierarchy disclosure (including the observability of market data sources, and its review, documentation to ensure correct classification at either Level 2 or 3).

At a time when all of these elements of a banks' operations are under stress via remote working or decreased FTE capacity, combined with a volatile market that is the basis for the valuation of most of these instruments, banks should expect continued scrutiny from the supervisor as was indeed confirmed by Andrea Enria in a recent letter to Marco Zanni, member of the EU Parliament.

Therefore, as banks approach half year reporting, key aspects that banks may wish to consider include:

– **Do some instruments need to move from Level 2 to Level 3?** There has been a reduction in quotation for market implied inputs which may lead to fixed income securities and even vanilla OTC products previously classified as Level 2 to level 3. Some equity derivatives could also need to be reclassified due to an increase in judgement in dividend projections.

– **Do I need to revise policies or other supporting documentation?** The current crisis may require changes in the existing IPV process, and any valuation methodology changes need to be reflected accordingly. This includes any transition from mark-to-market to mark-to-model approach that will impact levelling of investments.

– **Have policies around observability been considered in the current context?** Fair Value Hierarchy methodologies based on criteria such as number of market quotes and the dispersion among them would trigger a re-classification in this context due to reduced observability / consistency of market data. In addition, banks may need to consider closely significant intraday movements and decline in price quotations that create additional parameter uncertainty, which may affect the observability of valuation parameters and affect the Fair Value Hierarchy.

The list of course is not exhaustive, and fair value measurement is a pervasive and judgemental issue. Banks should continue to revisit their governance framework, policy documentation and policies surrounding key supervisory issues such as observability to ensure that they are capturing the ongoing volatility and market uncertainty in a compliant manner.

For more information on this topic, please contact Maureen Finglass, Julia Schießer and Elena Nagy.

SREP 2020 pragmatic approach

Since the COVID-19 outbreak, not only have financial institutions been put to the test, but supervisors have also been challenged to efficiently and effectively carry out their supervisory activities. On 13 May 2020, the ECB announced that its annual core activity, the Supervisory Review and Evaluation Process (SREP), will undergo some pragmatic changes this year, focusing on "the most material risks and vulnerabilities related to the crisis" and banks´ ability to withstand the related impacts with regard to the four elements of the SREP (business model and profitability; internal governance and risk management; risks to capital; and risks to liquidity and funding).

Although the details of SREP 2020 have not been fully disclosed, it is clear that ICAAP and ILAAP will play a fundamental role in revealing how well banks have managed in this challenging time and the future expectations in terms of impacts and mitigating actions. The ICAAP and ILAAP (also referred to as ICLAAP) are key sources of information for understanding how banks are managing both capital and liquidity. Data availability and sound ICLAAP reporting will form the base of ECB's upcoming assessment, which, even though is expected to leave P2R and P2G requirements stable in most cases, could highlight banks´ vulnerable areas and eventually trigger ad-hoc investigations. In any case, SREP main outcomes will be publicly available therefore it is important for banks not to underestimate the exercise and its potential implications.

Additionally, based on public information disclosed by the ECB, SREP 2020 will focus on "banks' capacity to handle this crisis and manage its impact in the coming months". Therefore, banks should expect to be challenged especially on those areas directly impacted by the crisis, including capital and liquidity management, both from a short and medium-term perspective. Banks´ ability to forecast risks evolution in such unprecedented stressed scenario should allow them to define and support a credible business plan. Furthermore, it is important to acknowledge that the ECB macroeconomic scenarios are expected by early June and should therefore be factored in banks´ projections to be considered for further discussions with JSTs. Additionally, the EBA's publication on 25 May 2020 regarding the first insights into the COVID-19 impacts for the banking sector, already provides some relevant scenario analyses including CET1 impacts (although not considering the effects of loan payment moratoria and guarantees) which banks can leverage upon.

To summarise, reliable and updated information, particularly the most recent data incorporating the latest effects of the crisis, will be crucial both for banks and supervisors. Institutions would want to provide an accurate and comprehensive picture of their current situations and managing actions in place, ensuring full transparency on their provisioning approaches and calculations, while the latter would want to collect comprehensive data reflecting and confirming banks´ views. Therefore, we expect the frequency and number of meetings between banks and supervisors to remain high in the near future until at least the supervisory dialogue on SREP will take place later this year. Since the ECB envisages to keep P2R and P2G stable for the most part, qualitative measures are going to be key outcomes of this year's SREP. Thus, properly managing interactions with the JSTs during the period leading to the SREP conclusion will be important. We acknowledge that Brexit banks are likely to be an exception to the rule since they were not subject to SREP in 2019. The ECB needs to determine both quantitative as well as qualitative elements of the respective SREP decisions. However, we believe that the scores for the SREP elements will also depend on Brexit banks' management of COVID-19 risks and vulnerabilities.

Next steps

In our view, in order to be prepared for the 2020 SREP cycle, banks should:

– Focus on COVID-19 related risk areas and corresponding managing actions, ensuring timely reporting to the supervisor, since potentially identified weaknesses could still trigger deeper assessments;

– Update stress scenarios, including information coming from supervisors and regulators, and factor them in into projections to support a credible business strategy for the near future;

– Expect to be further engaged in discussions with the JSTs, which will play an even more crucial role compared to previous years; and

– Expect potential additional data requests throughout the next months, which most likely will be factored in the SREP assessment.

For more information on this topic, please contact Niccolò Anatra, Sofia Pignatelli and Pedro Gil.

Key links

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

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