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KPMG SSM COVID-19 Insights

KPMG ECB Office alert

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 **(as of 27 March 2020).**

The ECB's actions are twofold, impacting both supervisory activities and monetary policies.

Regarding supervisory activities:

- 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.
- **Dividends**
  - The ECB have asked banks not to pay dividends or buy back shares during COVID-19 pandemic. This recommendation concerns dividends for 2019 and 2020, at least until 1 October 2020.

Source: More details from the ECB can be found here.

Regarding monetary policy, the ECB announced the following measures:

- **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**.**

New supervisory activities impacting banks´ regular activities in light of COVID-19 measures:

Date	Body	Further details
26 March	European Commission	Under the State Aid Temporary Framework to support the economy in the context of the COVID-19 outbreak, the European Commission approved state aid schemes and found guarantee schemes for several jurisdictions. An updated list can be found here: https://bit.ly/2vVbK0S
26 March	FCA, FRC and PRA	The FCA, FRC and PRA announced a series of actions to ensure information continues to flow to investors and support the continued functioning of the UK's capital markets. Read the statement here: https://bit.ly/2QP5pLA For details on FCA/FRC and PRA updates, please visit the Financial Services Regulatory Insight Centre here: https://bit.ly/3bvXVVH
25 March	ESMA	The ESMA issued a Public Statement on some accounting implications of the economic support and relief measures adopted by EU Member States. The measures include moratoria on repayment of loans and the impact on the calculation of expected credit losses in accordance with IFRS 9. Read the statement here: https://bit.ly/2WH9uFv
25 March	EBA	The EBA provides clarity to banks and consumers on the application of the prudential framework. Read the second statement issued here: https://bit.ly/3dwdIWn
25 March	EBA	The EBA released a statement on the application of the prudential framework regarding Default, Forbearance and IFRS 9. Read the statement here: https://bit.ly/2QMQNfI
25 March	EBA	The EBA released a statement on consumer and payment. Read the full statement here: https://bit.ly/3ajYQIM
25 March	EBA	For the postponed EBA activities and further actions to support banks' focus on key operations, please follow this link: https://bit.ly/3buvF5W
24 March	ESRB	Several jurisdictions have announced that they are reducing their Countercyclical capital buffer (CCyB) rates. This is the case so far in Belgium, Denmark, Germany, Iceland, Norway, Sweden and the United Kingdom (list of countries from the ESRB, last updated 24 March). More details can be found here: https://bit.ly/33M4Szr
20 March	BCBS	The BCBS held a conference call on 20 March to discuss the impact on the global banking system. In the immediate term, the Committee is suspending consultation on all policy initiatives and outstanding jurisdictional assessment planned in 2020 under its Regulatory Consistency Assessment Programme. For more information, click here: https://bit.ly/3bxnVA9

New supervisory activities impacting banks´ regular activities in light of COVID-19 measures (contd.)

Date	Body	Further details
20 March	FSB	The FSB released a statement to encourage authorities and financial institutions to make use of the flexibility within existing international standards. Many members of the FSB have already taken action to release available capital and liquidity buffers, in addition to actions to support market functioning and accommodate business continuity plans. Read more here: https://bit.ly/3dvCeqt
20 March	BOE	The Bank of England announced a package of measures in response COVID-19. Read the latest from the Financial Services Regulatory Insight Centre here: https://bit.ly/33M6OaU
12 March	EBA	The EBA released a statement on actions to mitigate the impact of COVID-19 on the EU banking sector. This includes the recommendation for NCAs to make full use, where appropriate, of flexibility embedded in the regulatory framework. In addition, the postponement of the EU-wide stress test to 2021 is also acknowledged. Read more here: https://bit.ly/3dwaxxY
11 March	ESMA	The ESMA outlined four key recommendations made to financial market participants. This includes: Business Continuity Planning, Market disclosure, Financial reporting and Fund Management. More details can be found here: https://bit.ly/2UGuvx9

Topic specific points of view

- **Liquidity Management**
- **Capital Management**
- **Accounting**

Liquidity Management

The ECB is closely monitoring the developments related to liquidity risk at banks, and we are aware of very regular calls *(often daily)*, including requests for ECB banks to file liquidity stress test reporting as well as detailed analysis on key liquidity risk drivers.

It is clear that most **banks have either activated their contingency funding plan or their recovery plan, and at the very least are in the process of discussing with their respective committee**, which decides on activation of the contingency funding plan or recovery plan. This is due to several factors including early warning indicators being triggered due to widening spreads, worsening of liquidity positions driven by market volatility and respective margin calls, increasing draw-downs of facilities and a general decreasing market liquidity, especially in the FX market and Bond market. Regulators and supervisors however are working hard to find solutions regarding these market constraints.

Banks will need to consider the following points in these circumstances:

- Proper and **timely reporting on key liquidity metrics** and responding to regulatory and stakeholder requests;
- Proper **monitoring around key liquidity outflows** – in particular facilities (existing exposure per currency, location and customer type, simulation under draw-down scenarios);
- Close and tight management of positions incl. intraday flows

- Ongoing **refreshment of contingency funding plan** and recovery plan measures incl. clear understanding on available collateral – in light of current crisis; and
- Ongoing internal communication with clear and documented decisions around:
  - Measures take
  - Measures to be executed
  - Follow-ups

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

Capital Management

COVID-19 has dramatically changed the state of play and the conditions in which banks operate. Governments, the ECB and other major monetary authorities have initiated a wide range of measures in the attempt to tackle the immediate impacts of a global economic break and to ensure that banks continue funding the real economy.

The public measures taken, have resulted in an unprecedented stop of economic activities across the globe. As a response, firms are drawing their credit facilities. The macroeconomic environment will most likely impact banks capital due to significant increases in exposures to corporates and households in (temporary) financial distress. More specifically, banks are expected to be faced with significantly higher capital demand due to above average number of rating migrations across their corporate portfolios (particularly SMEs), potentially increasing IFRS 9 stage transfers. Heightened market volatility, increased credit spreads and higher bid-ask-spreads are likely to materialize in higher Value-at-Risk (VaR) numbers and an increase in Prudent Value Adjustments (PVA).

The ECB's 2019 SREP did not bring many changes regarding capital, despite stronger supervisory focus on qualitative requirements and a further worsening of the SREP scores on risk management and internal governance. Going forward, the unexpected COVID-19 impact on banks will inform the SREP 2020 and the ECB's supervisory focus. The focus will again be on quantitative requirements, based on the capital and liquidity relief recently announced by the ECB on 12 March 2020 and the subsequent actions by NCA's.

Average effects

Measure	Impact on CET1 Capital
Release of P2G	~150 bps
Release of CCB	250 bps
Use of AT1 and T2 instruments	~90 bps
Release of CCyB	~30 bps
Total	**~520 bps**

Source:

Measures taken from: ECB Banking Supervision provides temporary capital and operational relief in reaction to coronavirus.

P2G, CCB, CCyB figures: ECB publication: Supervisory Review (SREP) – Aggregate SREP outcome for 2019.

AT1 and T2 instrument figures from: ECB SREP methodology 2019 and the Introductory statement by Andrea Enria, Chair of the Supervisory Board of the ECB, at the press conference on the results of the 2019 SREP cycle

What does this mean for SSM banks?

Supervisors signalled large degrees of flexibility regarding capital requirements, which will significantly impact banks' capital planning processes, capital management and the overall risk culture. While providing the real economy with up to EUR 1.8 trillion new funding, banks will need to find the right balance, carrying out a reasonable risk taking in accordance with the defined risk culture. ECB expects banks to play a key role in supporting real economy and to provide immediate funding in the attempt to avoid a harsh economic crisis. Banks should not overlook other initiatives that may also impact their capital management and planning such as Basel IV.

Furthermore, banks should also take into consideration both ICAAP and lessons learnt from the risk by risk exercise as part of comprehensive scenario analyses. ICAAP is more relevant than ever as a managerial tool during this turbulent time, even if the ECB finally decides to skip the submission of ICAAPs for 2020. In addition, now is the time to identify, measure and analyse each single risk to avoid large losses of capital, especially in the situation where banks will operate with lowered capital levels and potentially weakened resilience.

Supported by large fiscal measures, these SSM actions should not lead banks to reduce their risk sensitivity nor forget the lessons learnt from the 2008-2010 financial crisis. It is not the time to undo, instead to be the key for recovery. Click here **to read the full article**.

For more information on this topic, please contact Sofia Pignatelli, Pedro Gil or David Nicolaus.

Accounting

Following on from the ad-hoc calls between the ECB and audit firms on Friday 20 March and Thursday 26 March, there have been several publications on accounting to clarify certain expectations in the market place. Understandably, the Definition of Default, Forbearance and IFRS 9 are taking centre stage.

On 25 March, the EBA published a statement supporting measures taken by national governments and EU institutions to address the systemic issues arising from COVID-19. The consensus is that public and private moratoria issued by governments directly as a response to the COVID-19 epidemic do not have to be classed as for forbearance measures, as for IFRS 9 and the definition of default, when they are addressed to a broad range of product classes. However, banks should be aware that there is still firmly an expectation that they should continue to assess the credit quality of exposures benefiting from these measures and be sure to identify any situation of unlikeness to pay off the borrowers accordingly.

Prudential identification of default

- The EBA states that their guidelines account for the possibility that public moratoria may extend past 90 days, and therefore defaults do not have to occur for moratoria activated as a result of COVID-19 material credit obligations. Criteria will be published in the near future to clarify to the industry.

- If it is likely that obligors will meet the commitments of renegotiated loans, then there is no need to classify the loan as defaulted, nor should it be a distressed restructuring.

- When public or private moratoria permit the suspension of payments, institutions must assess the obligor's unlikeliness to pay on a case by case basis carefully, not on an automated basis and should priorities portfolios accordingly.

Classification of Forbearance

- No automatic reclassification required is needed under terms of a general moratoria, since these are being introduced to address systemic risks and alleviate potential risks that may occur in the wider EU economy in the future and so are not borrower-specific. Definition of forbearance by the EBA is designed more on an individual borrower basis.

EBA Considerations on IFRS 9

- The EBA's joint statement with ESMA confirms that IFRS 9 has flexibility, and due to the quantitative and qualitative aspects that it contains, means that there is no strict automatism to consider. The EBA considers that public or private moratoria due to COVID-19 should not be considered **by themselves** to be an automatic trigger to conclude that a significant increase in Credit Risk has occurred.

- Institutions should be sure to consider all information, including forward looking information that may affect the credit risk of a financial instrument since recognition. The EBA expects banks to distinguish between obligors for which the credit standing would not be significantly affected by the current situation in the long term, from those that would be unlikely to restore their credit worthiness.

- The existence of public guarantees or collateral should be considered in determining the impact on banks' income statements stemming from the recognition of ECLs.

- The EBA will continue to monitor the situation, particularly given their benchmarking on IFRS 9.

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).

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