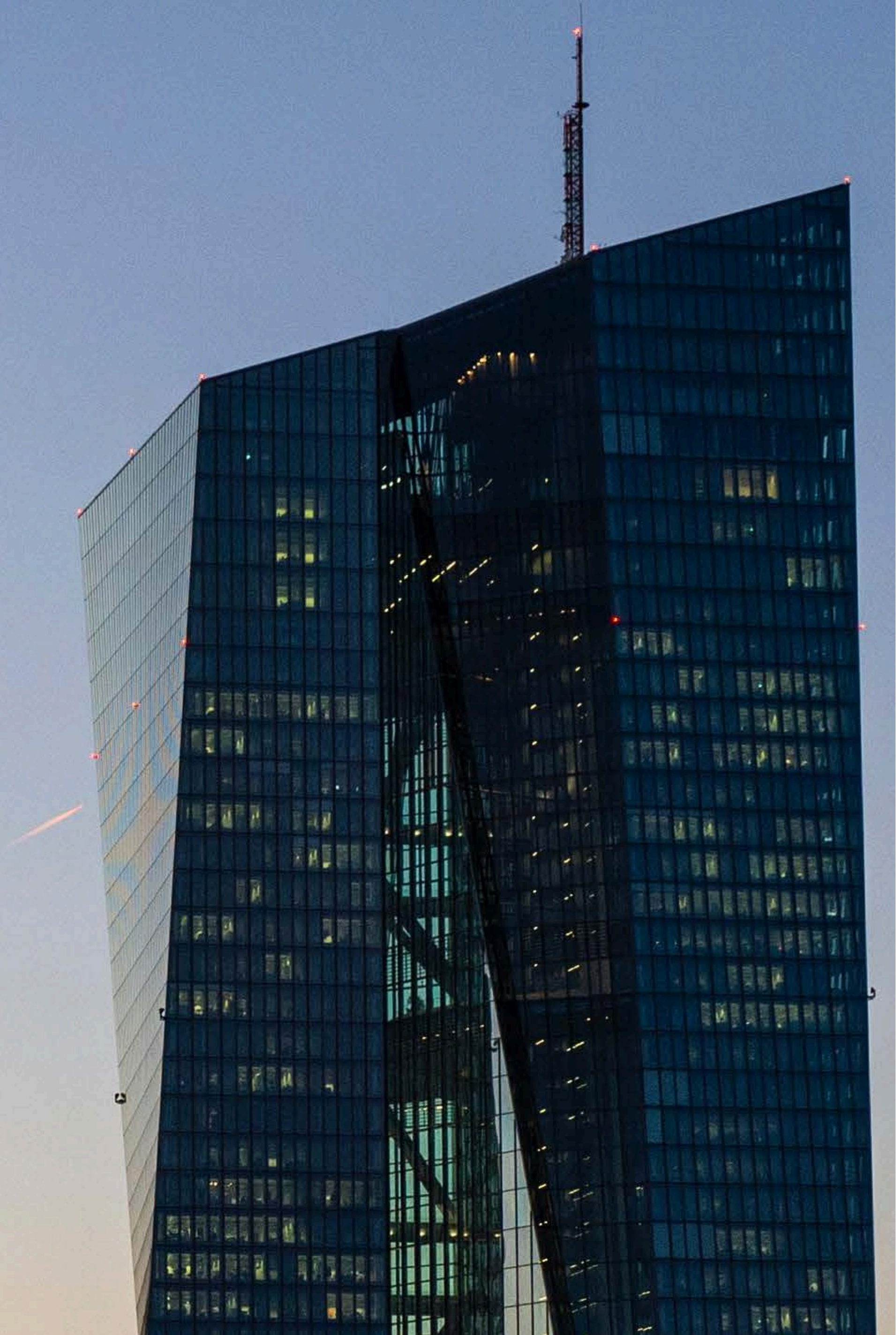
KPMG

SSM supervisory priorities 2021



Deep dive into key focus areas

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February 2021

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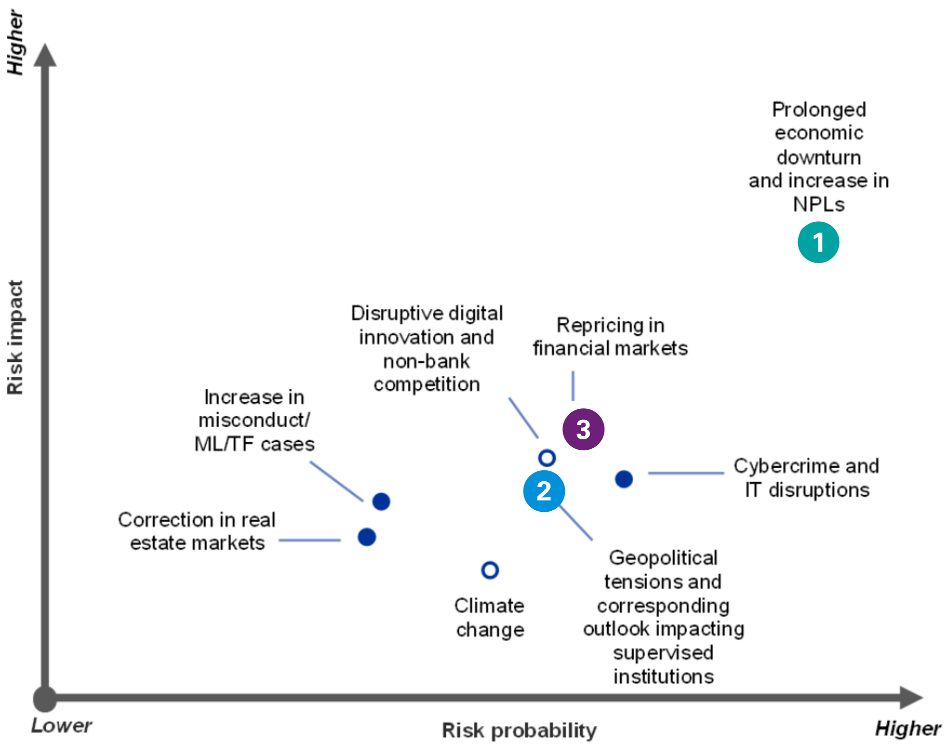
ECB risk assessment 2021 is the starting point for identifying critical risk drivers

The European Central Bank’s assessment of risks and vulnerabilities in 2021 has been informed predominately and expectedly by the COVID-19 pandemic and the associated high uncertainty around the macroeconomic outlook.

SSM RISK MAP 2021



Source: ECB Banking Supervision, 2021

KEY DRIVERS OF BANKING SECTOR RISKS

1 Prolonged economic downturn and increase in NPLs;

— The outbreak of the pandemic, related lockdown measures and resurgence of the virus towards the end of 2020 have increased uncertainty in the economic outlook, resulting in an increase in NPLs.

2 Renewed geopolitical tensions and corresponding outlook impacting Systemically Important financial institutions

— Remerging trade conflicts could have a negative impact on euro area growth, and in a worst case scenario, abrupt reassessment of risk premia and repricing in financial markets.

3 Repricing in the financial markets

— Though financial asset prices have rebounded strongly since the repricing episode in March 2020, there could be a disconnect from underlying economic fundamentals in some equity markets, thereby increasing the risk of corrections should investor sentiment change.

OTHER SIGNIFICANT RISK DRIVERS

— In addition to these, the ECB also named additional significant risk drivers in the short term: **Cybercrime and IT disruptions**; and, increase in misconduct, **Money Laundering and Terrorist Financing** cases; correction in **real estate markets**. Finally, risk drivers that are expected to increase strongly over the next five years include: **Climate change**; and disruptive **digital innovation and non-bank competition** (on the risk map in white circles).

ECB's view on existing bank vulnerabilities

In addition to the risk assessment, the ECB for the first time has clearly indicated their view of existing vulnerabilities, both internal and external to banks, that require supervisory action. Internal vulnerabilities can be addressed by banks themselves, whilst external vulnerabilities refer to the environment in which banks operate.

EXISTING BANK VULNERABILITIES

01 Internal to banks

- Weaknesses in management and coverage of credit risk
- Structurally low income levels and profitability
- IT deficiencies
- Weak governance, including weak strategic steering
- Lingering cost inefficiencies

02 External to banks

- High public and private debt levels in the euro area
- Overcapacities in banking
- Fragmentation in the regulatory and legal framework

Source: ECB Banking Supervision, 2021

The ECB remarked that the risk drivers on the previous slide could have an impact on supervised institutions through the above mentioned existing internal and external vulnerabilities prevalent in the banking system itself or in the economic environment in which banks operate. Based on the current risk picture, the identified key vulnerabilities have shaped the priority areas for supervision in 2021, as also outlined in SSM supervisory priorities for 2021.

ECB supervisory priorities for 2021

The supervisory priorities for 2021 have, therefore, been based upon the ECB's assessment of the key challenges facing supervised banks in the current economic, regulatory and supervisory environment as well as their view on existing vulnerabilities. Based on our conversations in the industry, we have on the following slides deep dived into the priorities where we see extensive activity and recommend banks to focus on in the coming months.

ECB PRIORITIES	DETAILS		Focus topics in this deck
Credit risk management	Ensure banks have adequate risk management practices in place to identify, measure and mitigate the impact of COVID-19 as well as the operational capacity to manage the expected increase in distressed borrowers.	1	Credit risk management
	Support banks in strengthening credit risk management, operations, monitoring and reporting.		
	Focus on capacity to identify deterioration in asset quality; make timely and adequate provisions; take necessary actions to manage loan arrears and NPLs, taking into account fiscal support measures and moratoria.		
Business model sustainability	Focus on business model viability and sustainability, as well as profitability exacerbated by COVID-19.		
	Challenge banks' strategic plans to overcome existing shortcomings.		
	Assess banks' progress in responding to the acceleration of digital transformation brought on by the COVID-19.	2	IT and cyber risks
Capital strength	Ensure adequacy of banks' capital positions and identify bank-specific vulnerabilities at an early stage.		
	Scrutinise appropriateness of banks' capital planning and challenge dividend and share buyback policies.		
	Gauge banks' capital resilience via the EU-wide stress testing coordinated by the EBA.		
Governance	Challenge risk data aggregation capabilities and risk information reported to management.		
	Follow up on banks' IT and cyber risk management practices and governance, including risks resulting from the outsourcing of services to third-party providers.	2	IT and cyber risks
	Scrutinise the operational resilience of banks i.e.: the adequacy of their crisis risk management frameworks.		
Beyond COVID-19	Focus on banks' alignment with expectations in the ECB Guide on climate-related and environmental risks.	3	Climate-related risks
	Assess banks' preparedness for the final stages of the implementation of Basel III.		

Deep dive into key areas

SSM supervisory priorities 2021

Credit risk management

Credit risk management

In their priorities, the ECB confirmed that they will continue their work to ensure that banks have adequate credit risk management in place to **identify, measure and mitigate the impact of credit risk,** as well as the **operational capacity** to manage the expected increase in distressed borrowers.

The 2021 priorities for credit risk revolve around:

- Focusing on further strengthening the initiatives already launched in 2020.
- Aiming to prevent the building-up of NPLs, by analyzing the effects of the COVID-19 pandemic and how the deteriorating macroeconomic environment will impact banks' asset quality.
- Maintaining and improving the adequacy of credit risk management, operations, monitoring and reporting
- We expect onsite and offsite activities during 2021 to focus on:
  - ✓ Banks' capacity to identify any deterioration in asset quality at an early stage.
  - ✓ Timely and adequate provisioning.
  - ✓ Capacity to appropriately manage loan arrears and NPLs.
  - ✓ Risk data aggregation capabilities.
  - ✓ Management bodies involvement in credit risk management.

What should banks expect?

In 2021, banks should expect an **increasing scrutiny of their readiness for further deteriorations in asset quality**, including their **ability to gauge the long-term viability of borrowers**. This focus has already been communicated to banks within the ECB's "Dear CEO" letter of 4 December 2020, which provided a reminder of the supervisory expectations for sound credit risk management in the context of the COVID-19 pandemic. These expectations are reiterated in the 2021 supervisory priorities. In 2021, we expect the ECB to:

— Perform **deep dives and send ad-hoc requests** focusing on vulnerable sectors of the economy such as hospitality, transport and high risk portfolios such as commercial real estate.

— Conduct specific **on(off)-site inspection** dedicated to the quality of banks' credit risk management, covering areas such as the early identification of risks, accuracy of reclassifications and the basis for provisioning decisions.

— Review and reassess collateral values.

— Reinforce its engagement around banks' **ability to dispose** of impaired assets.

— Monitor closely the effect of COVID-19 on banks' portfolios with **specific reporting requirements** (i.e. SSM COVID-19 reporting);

— Continue monitoring banks' **implementation of the EBA Guidelines on loan origination and monitoring**.

Furthermore, banks should also expect **follow-up action on internal ratings-based models** resulting from the TRIM findings, as well as the IRB repair programme that is currently in the process of being set-up.

How can banks get prepared?

The increased supervisory scrutiny on credit risks in the context of COVID-19 is expected to put additional pressure on banks, with many institutions already struggling to fully comply with the requirements set in 2020. Banks are now required to take a long term, more strategic and pre-emptive approach to credit risk management. This will require changes across a broad range of areas.

Banks should prepare themselves by:

— Identifying critical portfolios and borrowers to evaluate sustainability of business models.

— Reviewing processes around default and forbearance classifications.

— Increasing capabilities and resources of Work-out Units (WoU).

— Reassessing collateral values.

— Amending strategies for NPL management and loan origination.

What we recommend as KPMG

Banks should define how they can integrate a revised approach to credit risk into their wider strategic efforts. The Dear CEO letter on credit risk is a reference for banks to improve their credit risk management in line with supervisory expectations. The EBA Guidelines on Loan Origination and Monitoring also remain a key reference for implementing these changes.

For more insights related to credit risk management beyond COVID-19, please read our paper here.

SSM supervisory priorities 2021

IT and cyber risk

IT and cyber risk

- For the third year running, the ECB has confirmed that it will continue its supervisory focus on banks' **IT and cyber risk management** practices and governance, including risks resulting from the **outsourcing** of services to third-party providers.
- This is complemented by the fact that **cyber crime and IT disruptions** are highly positioned in the **SSM Risk Map.**
- Furthermore, the ECB has identified **IT deficiencies** as one of the **key internal vulnerabilities in the banking sector** in 2021.
- Regarding the future of bank business models, within the **Business model sustainability section**, the ECB has highlighted how the COVID-19 pandemic has accelerated the process of digital transformation, and will for the first time engage in additional supervisory assessments of banks' progress in response to these developments, along with how bank management is overseeing **digitalisation** in their business strategies.
- This echoes the recent publications at the end of 2020 in the space of Digital Finance from the **European Commission** and other regulatory bodies.

What should banks expect?

– In 2021, banks should expect the ECB to follow-up on the **key vulnerabilities** identified in their horizontal analysis of the **IT Risk questionnaires** (IT governance, Data quality management, IT risk management; the use and management of "end-of-life" systems for critical processes, outsourcing concentration risk).

– In addition, we may see an increase in **remote "off-site" inspections** on **IT Risk Management topics**, including the assessment of banks' compliance with the most recent **EBA guidelines** (ICT and security risk management, outsourcing etc), or resuming previously paused supervisory activities.

– Regarding **digitalisation**, recent comments from **Fabio Panetta, Member of the Executive Board of the ECB,** should be viewed as a statement of intent: "*The digital transformation is here to stay. But for digitalisation to contribute to economic resilience beyond the pandemic, cyber resilience will be paramount. Otherwise, digitalisation may increase risks rather than reduce them.*"

How can banks get prepared?

– Banks should begin to assess the developments that have been made in **digitalisation** in 2020, from a **strategic, business and regulatory perspective** and analyse gaps in these areas, especially taking Fabio Panetta's comments into account.

– **ICT risk management and third party risk**: Banks should assess the current measures in place to address ICT risk and to ensure a high level of digital operational resilience that matches their business needs, size and complexity. It is important that banks comply with principles to manage third party risk and maintain a clear register of outsourcing arrangements not only at individual level but also at consolidated and sub-consolidated levels.

– **Cloud strategy:** Banks should define cloud objectives and targets as part of overall cloud strategy as well as analyse existing IT structures and applications in order to compile valuable cloud target operating model.

– Furthermore, banks should participate in the **cyber resilience strategy** of the ECB, and become involved in the intelligence sharing initiative, proactively engaging with the ECB on digitalisation and cyber resilience topics.

What we recommend as KPMG

– KPMG offers extensive FS industry-specific domain knowledge, combining ri**sk and compliance experience,** deep **technical IT / cloud implementation expertise and practical organisational** change management. For example, KPMG maintains **strategic partnerships** with key players (incl. AWS, Google Cloud and Microsoft Azure), combining advanced technologies with comprehensive consulting expertise to support your cloud transformation goals.

– KPMG can support in bank **digitalisation strategic projects**, including **assessing business models**, **target operation model review** and impact analysis as well as accelerating banks' "journey to the cloud" end-to-end.

Climate-related risks

Climate-related risks

- For the third year running, **the ECB included climate risk in the SSM risk map**, as a clear signal of increased supervisory attention to the topic.

- For the first time, within the 2021 priorities, the ECB has confirmed that it will formally carry out activities in the course of 2021 to assess banks' alignment with **the expectations set out in the ECB Guide on climate-related and environmental risks**, published in November 2020.

The guide:

- Explains how the ECB expects banks to prudently manage and transparently disclose climate change risks under current prudential rules.
- Includes 13 expectations for the ECB's supervisory dialogue with significant institutions.
- Covers the entire risk management universe, potentially meaning banks may have to significantly adjust their business practices.

The ECB has already requested significant institutions to perform a **(i) self-assessment of their alignment with the expectations** and (ii) to provide a **roadmap for implementation**. Banks will be requested to justify any divergences from the expectations.

What should banks expect?

- In 2021, we expect that the ECB will follow-up on the **key vulnerabilities** that were identified in their **Climate-Disclosures survey** from 2020, **and banks' alignment with the supervisory expectations** outlined in the Guide on climate-related and environmental risks**.** In particular, we expect the ECB to focus on the integration of climate and environmental risks on banks' strategy & organisation, governance & risk management, as well as reporting & disclosures.
- Furthermore, with a view to the long-term, banks should expect **increased supervisory focus** in preparation for the upcoming **climate stress test** exercise **announced for 2022**.
- **Increased scrutiny in the area of climate risk** should be confirmed by the recent statement from **Christine Lagarde, President of the ECB**: "*I want to explore every avenue available in order to combat climate change*."

How can banks get prepared?

- If not already begun, banks should immediately assess their internal controls and processes to identify **how well** climate-related risks have been integrated into their risk management systems, and identify and **analyze gaps** in these areas, especially **in light of the ECB's supervisory expectations,** as well as the work of other supervisory and regulatory authorities.
- Banks must **define objectives and targets** as part of their overall **strategy to integrate climate risk into their strategies and processes,** as well as analyze existing structures in order to **assess possible customer needs.**
- Furthermore, banks should **engage** in dialogues regarding the status of this integration **with regulators and supervisors** in order to ensure transparency of gaps in their internal processes, and discuss and agree on their strategy to an appropriate target operating model that incorporate said risks.

What we recommend as KPMG

- KPMG has extensive **ESG expertise** that covers a broad variety of different aspects included in the ECB Guide on climate-related and environmental risks – and beyond. For example, KPMG has a strong **strategic cooperation** with specialised data providers - e.g. Southpole – and together we are able to expand climate-related scenarios in terms of local effects.
- KPMG can provide support in the **integration of climate-related risks into banks' risk management framework** in line with the ECB's supervisory expectations.
- Based on the significant **experience in implementing scenario analysis and risk models**, KPMG can support banks **in developing methods and processes for quantification and simulation**, and gather data to define climate-related scenarios.

For more insights related to climate-related risks, please listen to our recent webcast here.

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