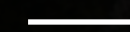
Credit risk

Current changes in the supervisory landscape and what banks can expect in the new normal

SSM beyond COVID-19 series

December 2020



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Introduction

The COVID-19 pandemic and its associated economic slowdown have had a major impact on global credit risks. These effects are likely to be felt for years to come and will inevitably affect banks' profitability and capital levels. Managing credit risks intelligently will be key to banks' ability to maintain their financial strength while continuing the supply of credit to households and businesses.

Public authorities have used the full flexibility of regulatory and supervisory frameworks to introduce a wide range of measures including capital and liquidity relief, payment holidays, moratoria and public guarantees. Their overall goal has been to create a 'circuit breaker', preventing procyclicality from further increasing credit risks.

However, banks and supervisors are also very aware of the need to closely monitor credit risks and avoid moral hazards. Moratoria may provide a breathing space, but they do not eliminate risks. It is important to strike a careful balance between adequate provisioning, prudent lending and institutional resilience while continuing to ensure fair treatment of customers.

Looking ahead, existing frameworks for the management of credit risks and the measurement of expected credit losses will need to be strengthened, allowing banks to react quickly, navigate risks and foster resilience amidst the altered environment of the 'new normal'. It's no surprise that credit risk remains central to the ECB's priorities for 2021, a clear indication that supervisory pressure is likely to continuously increase in the following months. Banks should also consider establishing a contingency plan for withstanding other periods of heightened uncertainty. The impact of COVID-19 on credit risk is only just beginning.

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Regulators, supervisors and governments reacted quickly to mitigate increasing credit risks

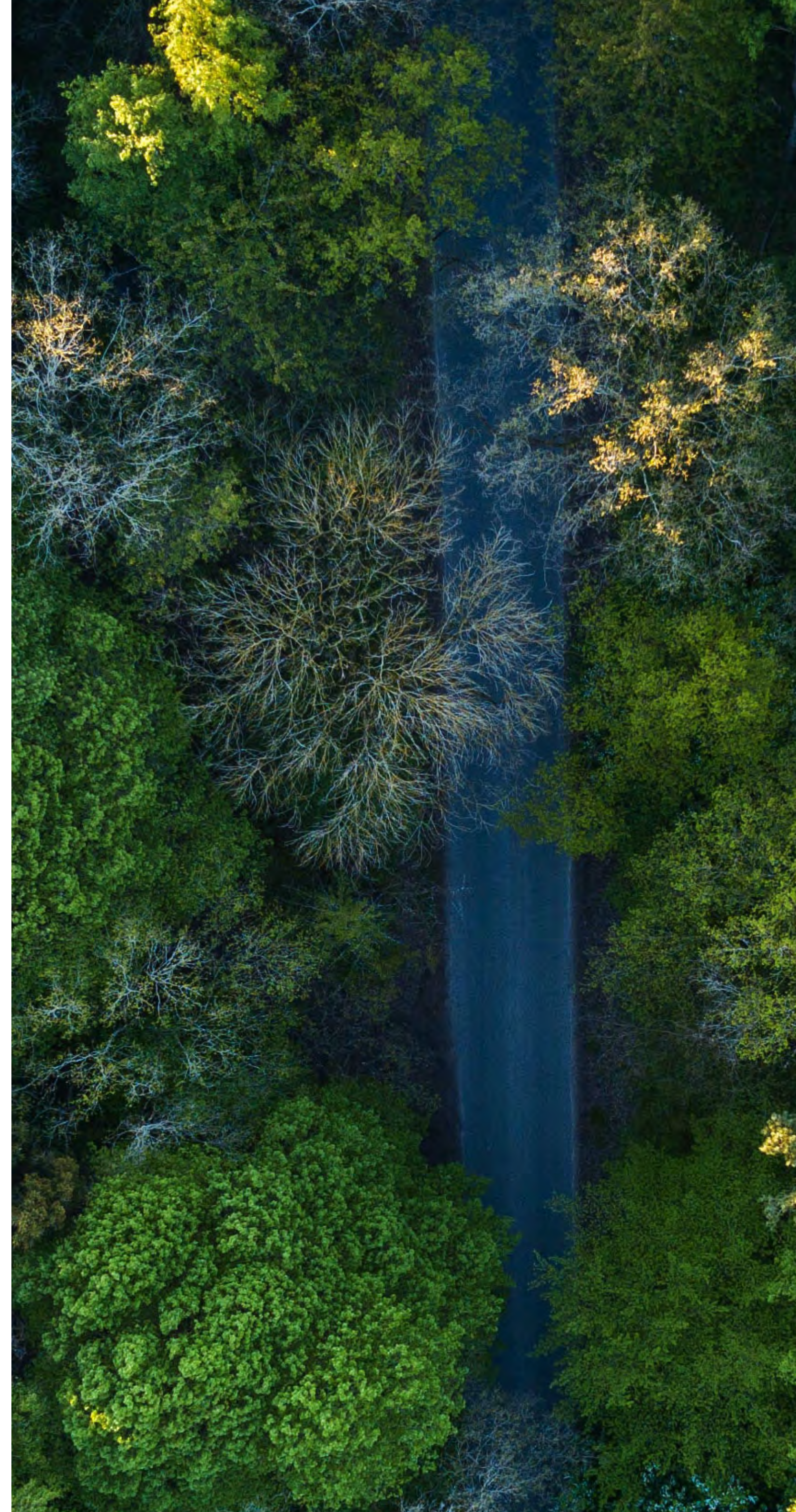
Improving banks' management of credit risks has been a key objective for supervisors ever since the establishment of the Single Supervisory Mechanism. Before COVID-19 struck, the ECB had identified several credit-focused priorities for 2020 including:

– Following up on banks' implementation of the ECB's latest NPL guidance, in order to further reduce the aggregate level of NPLs;

– Following up on TRIM findings, with a particular focus on the EBA's IRB repair programme as it relates to credit risk models; and

– Assessing credit underwriting criteria, with a focus on potentially risky portfolios such as real estate and leveraged lending.

Banks had also begun preparing to implement the EBA's far-reaching Guidelines on loan origination and monitoring. These aim to reduce the inflow of NPLs by ensuring that new loans are of high quality from the point of origination right through to redemption.



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It was against this background that the onset of COVID-19 led regulators and supervisors to initiate a programme of actions intended to avoid procyclicality and maintain the supply of credit to the economy while ensuring that banks maintain strong capital resilience. These efforts, taken at the national, European and global levels, can be roughly divided into three key areas.

On **credit quality and strategies**, national and industry-wide moratoria were introduced, with the EBA issuing guidance that payment holidays granted should not trigger classifications of forbearance or distress. The ECB and European Commission (through the "quick fix" to the CRR) also increased banks' ability to take flexible approach to NPL provisioning, by allowing the preferential treatment of NPLs benefiting from guarantees granted by national governments or other public entities.

- EBA payment moratoria Guidelines, EU government payment moratoria and public guarantees;
- ECB flexibility in the treatment of impaired loans, NPLs provisioning and NPLs strategy (until March 2021);
- CRR quick fix changes in NPLs provisioning (prudential backstop – calendar provisioning).

On **credit risk models and capital**, supervisors took several steps to introduce flexibility into regulatory requirements and encourage banks to keep lending. These included the ECB allowing banks to reduce their capital below the levels of the Pillar 2 Guidance (P2G) and Capital Conservation Buffer (CCB); the Basel Committee making a number of regulatory amendments; and the European Parliament passing a "quick fix" package of amendments to the CRR to reduce capital requirements.

- ECB capital and liquidity relief which allows bank to operate below the Pillar 2 Guidance (P2G) and Capital Conservation Buffer (CCB);
- BCBS guidance to reflect impact of COVID-19 on regulatory capital (RWA of loans subject to sovereign guarantees, past-due identification for loans subject to COVID-19 related payment deferrals);
- CRR "quick fix" to allows an anticipated application (entry into force from 27 June 2020) of:
  - CRR2 related adjustment of risk weighted non-defaulted SME exposures;
  - CRR2 new supporting factor for exposures to entities that operate or finance physical structures or facilities, systems and networks that provide essential services;
  - CRR2 more favourable treatment of certain loans granted by credit institutions to pensioners or employees with a permanent contract.

On **IFRS 9**, supervisory and accounting authorities encouraged banks to take a balanced approach to credit provisioning, taking into account the levels of government support. Additionally, a 'new' dynamic component has been introduced for transitional arrangements, starting from 2020 and lasting two years. In turn, this should mitigate the impact of IFRS 9 ECL provisions on regulatory capital.

- Clarification from accounting authorities for applying expert judgement in order to arrive at a best estimate of expected credit losses in conditions of unprecedented economic conditions where credit models alone are insufficient in predicting credit losses;
- ECB letter to banks: banks should use the long-term forecast (e.g. the long-term GDP growth rate) whenever the specific forecast has lost relevance;
- CRR changes on transitional arrangements (TA) which allows the dynamic portion of ECL raised from 1 January 2020 to the respective reporting date to be added back to CET1 capital at the following percentages: 100% in 2020 and 2021, 75% in 2022, 50% in 2023, and 25% in 2024;
- Supervisors expectations to apply TA.

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COVID-19 has huge implications for the credit environment; banks are responding but face challenges

Despite the efforts of supervisors and public authorities, there is no doubt that the global credit environment has been changed by the COVID-19 pandemic, perhaps permanently. European credit markets are likely to be feeling the effects for several years. The following three sections summarise some of the most significant credit-related changes and challenges that banks have experienced to date.

Credit quality and strategies

Moratoria and public guarantees have helped to temporarily mitigate the credit impact of COVID-19, to the point that lower levels of insolvency and bankruptcy were reported in the first half of 2020 than during the equivalent period in 2019.

However, NPL levels and possible provisioning levels are likely to increase as government guarantees and credit moratoria are phased out in the future. In some sectors, businesses are unlikely to be able to return to normal capacity for some time, making it doubtful whether they will be able to resume contractual repayments after the expiry of payment holidays.

In response, banks have significantly stepped up their monitoring and reporting of credit risks. Most are focusing on their exposures to sectors that have been hardest hit by the downturn and which will continue to suffer during the slow recovery – such as transport and hospitality – and on portfolios seen as being at particular risk such as SMEs, commercial real estate and leveraged loans. This increase in high risk cases is putting significant pressure on credit risk management functions dedicated to managing borrowers, and on NPL work-out units.

At the same time, regulators and supervisors are stressing that - regardless of payment holidays - high quality credit assessments meeting pre-crisis standards must still be carried out, and that any deterioration in credit quality must be closely monitored. The EBA Guidelines on loan origination and monitoring require high quality internal standards with regard to risk. The ECB and EBA are also asking for new, detailed credit reporting at monthly and quarterly intervals respectively. In addition, banks face challenges to project the impact of COVID-19 on capital and asset quality and properly assess the unlikeliness to pay of borrowers.

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As they adapt to the altered conditions, banks are making a variety of changes to their credit governance, both with respect to new lending and to the management of NPLs. Some popular initiatives include:

– Amending strategies for NPL management and loan origination in response to events and supervisory guidance. In current circumstances, the need to implement the final EBA Guidelines on loan origination and monitoring is more important than ever. The ECB's **recent report** on credit underwriting standards, which highlights concerns over specific portfolios including residential and commercial real estate, also implies that banks should prepare for focused on-site inspections and deep dives.

– Increasing the capability and resources of work out units. Strengthening these teams will be hard, since all banks are chasing the same talent pool. Automation will help but is still likely to be supplemented by significant skilled input. Workout teams are also taking particular care to comply with legal and regulatory requirements on conduct, consumer outcomes and complaints handling.

– Reviewing processes around default and forbearance classifications in light of the temporary flexibility amendments introduced by national and European supervisors.

In parallel, banks are also reassessing their definition of default for compliance with the new EBA guidelines, which is effective on 1 January 2021 in the EU.

– Improving the efficiency of lending processes, with a particular focus on addressing pinch-points created by a shortage of experienced credit officers. This includes quick wins from relatively simple steps, such as using decision trees to 'triage' decisions before involving specialist staff.

– Assessing the potential for targeted disposals of loan portfolios, although these are likely to be challenging during a credit downturn.

– Developing strategies to make better use of scarce capital resources, for example by reviewing risk weightings and capital allocations more dynamically than in the past, or by increasing the use of 'originate to distribute' lending models and loan securitisation.

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

– Assessing current collateral valuations to analyse the potential risks adequately.

– Reviewing current reporting structures to ensure quick management actions are being taken when necessary.

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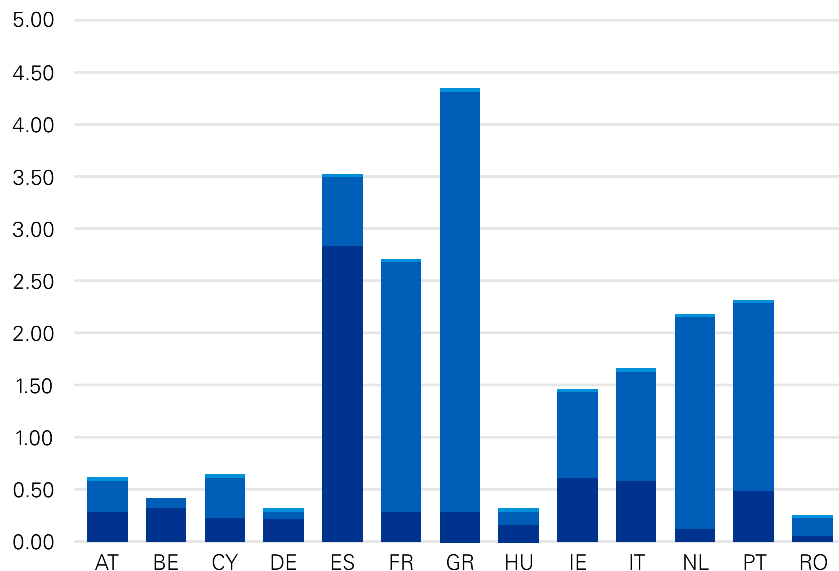
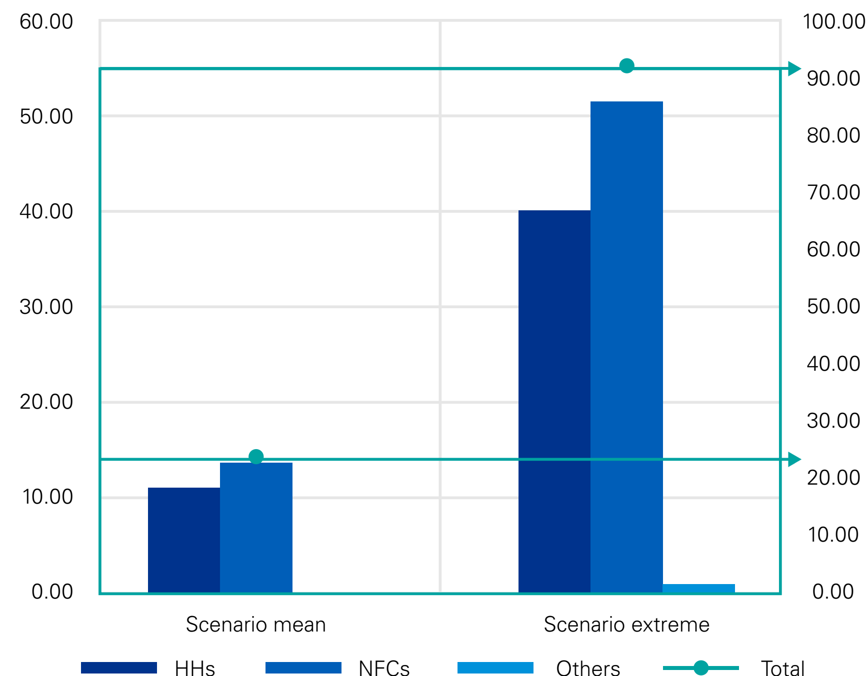
Based on the latest data published by the EBA in June 2020 and the results of various ECB analyses on past crisis impacts on NPLs, KPMG professionals have projected a potential provisioning gap for loans under moratoria post-crisis in the most extreme scenario. These figures support the fear of high impacts in the event of a sudden withdrawal of policy support - also referenced in the recent ECB press release **here**.

June 2020 - Volumes of loans under non expired moratoria classified as NPLs (€ bln)



Post crisis - Additional provisioning related to NPLs under moratorias (€ bln)



Footnote - **Basis data taken from thr EBA thematic note on the use of moratoria and public guarantees,** based on a sample of around 130 banks within Europe, using information of 30 June 2020.

The scope of the projections include only NPLs related to loans under active moratoria within the reported EU countries. Calculation do not take into consideration the movement of level of provisioning on performing loans.

- *NPL starting point adjusted to 2.7% from observed 2.5% in June 2020, to reflect EU NPL ratio for all loans of 2.7% observed by the EBA as EU average in December 2019.
- NPL coverage ratio for projected new NPLs under moratoria equal to 44.7%, instead of the observed 25% as of June 2020 which reflects a "wait and see" approach rather than pre-crisis situation. A coverage of 44.7% is in line with the coverage of NPLs observed by the EBA at EU level in December 2019.
- In line with the **ECB research bulletin Number 71 "COVID-19 and non-performing loans:lessons from past crises"**, it has been projected that the volume of loans under non expired moratoria classified as NPLs could increase 3 times to 10 times higher than in June 2020 adjusted* figure, leading to additional provisioning for loans under moratoria from €24.12 billion to €91.77 billion (evenly distributed between households and non-financial corporations, in line with the starting points). The extra provisions already incorporate a 1.5% provisions for performing loans under moratoria, in line with EBA observations. **(Source: KPMG International)**

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Credit risk models and capital

COVID-19 has brought exceptional volatility to credit risks. Public health measures are changing risk levels day by day, and economic forecasts are heavily influenced by political decisions. The time-limited nature of payment moratoria also creates the potential for 'cliff edge' changes to risk, and it's worth considering that the current situation could sow the seeds of future modelling bias, due to the actions taken by different governments to protect national income levels and creditworthiness.

Banks' regulatory IRB models, which rely on statistical modelling of historic data, are struggling to capture this rapidly changing picture. Banks are taking a variety of steps to overcome these model limitations by leveraging satellite models, ranging widely in sophistication. At the simpler end of the spectrum this may involve applying high-level economic assumptions at the portfolio level. More complex options include developing detailed, tailored forecasts and applying these to individual exposures.

Focusing specifically on IFRS 9 expected credit loss (ECL) models, some banks are developing enhanced governance frameworks around ECL modelling, given the way that COVID-19 is forcing them to use post-model adjustments to address:

- Uncertain macroeconomic forecasts;
- Models overreacting to macroeconomic scenarios and generating overly sensitive ECLs; and
- The potential delay in defaults to next year as a result of the extension of moratoria and additional forbearance towards borrowers.

Whatever the approach, banks face unprecedented modelling challenges. For example:

- 'Through the cycle' models based on historic data cannot timely predict borrowers' riskiness during exceptional events. One option could be integrating balance sheet forecasting into models. Banks that build this kind of flexibility into their modelling are typically much more efficient at adjusting ratings during sudden market shocks.
- Models cannot easily factor in the impact of relief measures such as government guarantees or payment moratoria. For example, payment holidays impact Probability of Defaults (PDs), while state aid could affect Loss Given Defaults (LGDs). Banks are carrying out top-down simulations to refine and update model assumptions around PDs, LGDs and credit conversion factors (CCFs).
- The crisis also has implications for the quality of banks' collateral portfolios, which is likely to affect LGDs. Banks are considering the pros and cons of systematic and ad-hoc revaluations, and of top-down or bottom-up approaches.
- The EBA's IRB repair programme has not been postponed, so banks are trying to continue working on this while also carrying out scenario simulations aimed at judging the capital impacts of different stressed conditions. The overall effect is to put significant strain on banks' limited modelling resources.

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IFRS 9

A recent **KPMG study** of seven European banks' third quarter results found that the average share of loans in Stage 2 increased from 6.77% at 31 December 2019 to 8.28% at 31 March 2020 and 11.31% at 30 June 2020, before declining to 10.34% at 30 September 2020. Over the same period, the proportion of loans in Stage 3 increased slightly but remained mostly stable.

While COVID-19 has depressed the macroeconomic outlook, it has not yet triggered a marked increase in defaults. The expected wave of insolvency and NPL growth is most probably still ahead of us. According to some banks, reclassifications from Stage 1 to Stage 2 are being made to anticipate future defaults. In the wholesale market, growing Stage 2 loans often reflect modelled increases in PD due to weaker economic forecasts and increased sector-specific risks. However, banks are heeding the EBA's recommendation that payment holidays should not trigger automatic transfers to Stage 2. Without the intervention of regulators and supervisors, it is clear we would be seeing greater increases in IFRS 9 provisioning.

Even so, the approach of cliff edge effects as payment moratoria expire means that stage transfer is only likely to accelerate. If banks have not made sufficient provision for future ECLs by moving enough assets to Stage 2, there will be an increase in that category once payment holidays and other government support measures are withdrawn. Anticipating this, banks are beginning to update their satellite models – typically used for stress tests rather than regulatory reporting – to model cliff edge scenarios ahead of time.

This calls for difficult judgements such as revisiting and justifying assumptions and forward-looking scenarios; identifying specific approaches for different sectors, territories and customer segments; and overlaying multiple assumptions on PDs, CCFs, collateral valuations and LGDs. Furthermore, this work is needing to be continually revisited as the credit cycle evolves, tying up precious credit expertise.

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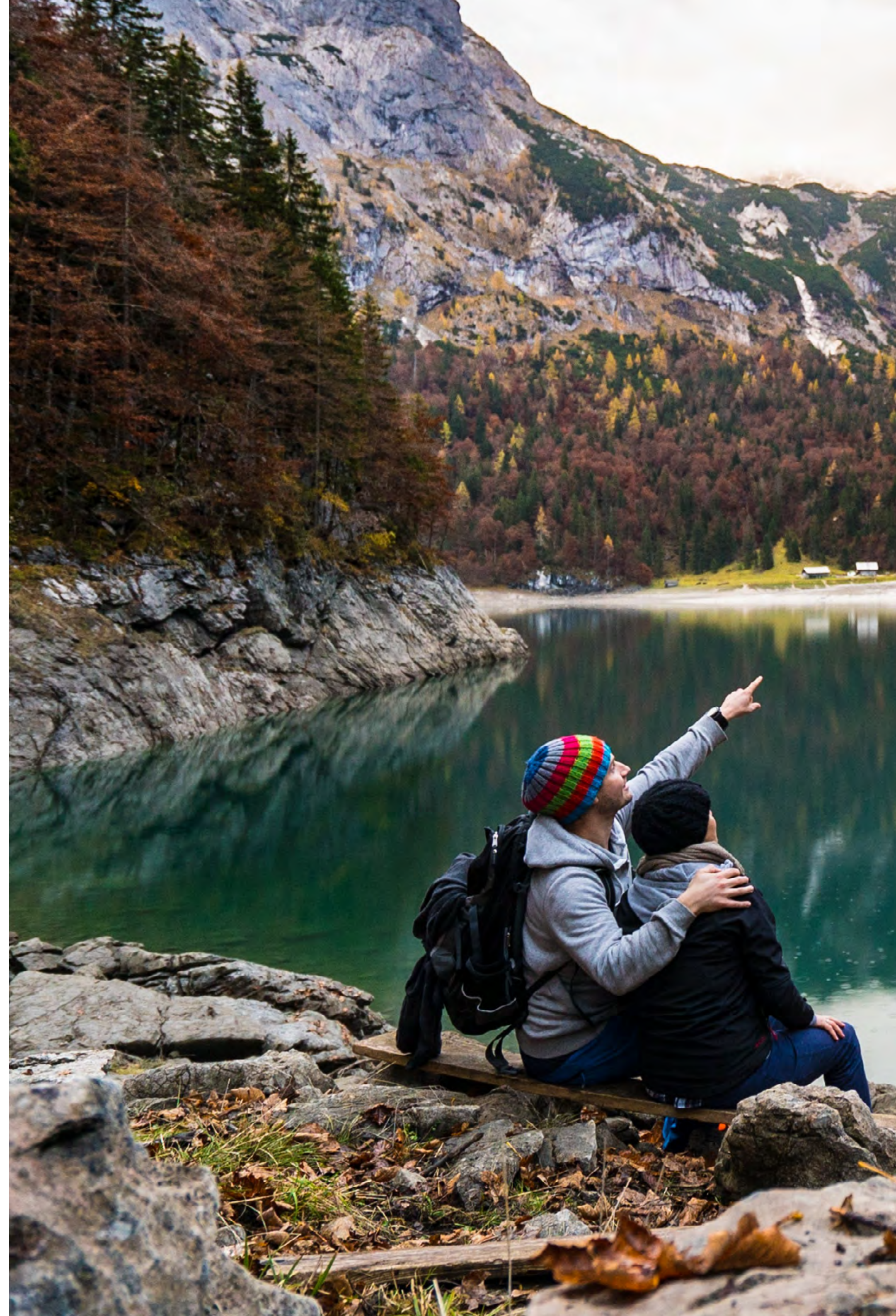

European banking is entering a new credit risk environment. The current crisis is not just creating what seems likely to be a prolonged downturn, it is also having a disproportionate impact on specific sectors and types of business. Banks are working to address them fast-changing outlook and the wide divergence between those sectors hurt by COVID-19 and the industries benefiting from the pandemic.

How can the industry begin adapting to this 'new normal'?

On the supervisory side, we expect the ECB to initiate a number of actions over the coming months. These are likely to include:

- Increased scrutiny of banks' readiness for further deteriorations in asset quality, including their ability to gauge the long-term viability of distressed borrowers.
- Heightened focus on banks' operational capabilities to manage NPLs, as noted by Andrea Enria in a recent interview **here**.
- More intensive ad hoc requests over banks' exposure to vulnerable sectors of the economy, such as hospitality and transport, and potentially risky portfolios like commercial real estate.
- Credit file reviews, deep dives and on/off-site inspections focused on specific portfolios or areas of credit risk.
- Enhanced scrutiny of the quality of banks' credit risk management, covering areas such as the early identification of risks, the accuracy of reclassifications and the basis for provisioning decisions, **also highlighted by Mr Enria here**.
- The 'Pragmatic SREP', which in 2020 focused on 'the most material risks and vulnerabilities related to the crisis'.
- Greater supervisory engagement around banks' ability to dispose of impaired assets, as illustrated by the **proposal of the Chair of the ECB Supervisory Board** to set up a European asset management company (or a European network of national asset management companies) benefitting from the level playing field of funding and pricing at EU level.
- 2021 stress tests applying more severe scenarios than before, with particular focus on elements that could affect credit, such as ESG factors and cyberthreats.

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Overall, these activities will add to the decisions on IRB models taken by the ECB following the TRIM exercise, and the corresponding remedial plans made by banks to address the model weaknesses identified. These overlapping requirements will require exceptional coordination and resource management to avoid bottlenecks and delays.

As for banks, they have much to do to respond to heightened supervisory scrutiny, to buttress their management of credit risks, and to begin adapting their credit strategies for a post-COVID-19 world. We see the following priorities – which carry varying levels of urgency - as the most important areas of focus.

Short term

In the short term banks should consider taking the following steps, if they are not doing so already, to ensure they can continue to manage the immediate credit effects of the pandemic effectively.

- Monitor and anticipate the evolution of payment moratoria, forbearance schemes and government aid packages, modelling their potential impact on asset quality, impairments and the origination of new loans. **ECB research** into 88 previous banking crises highlights that timely NPL resolution is critical to economic recovery.
- Carry out regular reviews of macroeconomic scenarios, modelling their effects on expected credit losses. A 'mild' scenario, in which a brief economic slowdown is followed by a rapid recovery in late 2020, now appears unlikely. Instead, it seems increasingly probably that European economies will suffer persistent output losses lasting well into 2021.
- Identify priority areas where clients and ratings should be reviewed, depending on their exposure to the economic conditions.
- Review risk appetite in the light of altered strategies, amended business models, revised capital thresholds or newly developed risk indicators.

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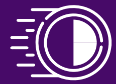

Medium term

In the medium term, we suggest that banks should take a range of actions aimed at striking the right balance between continuing to provide credit to households and businesses, and maintaining financial strength and systemic resilience.

– Make use of the current flexibility in regulatory and supervisory requirements to maintain the supply of credit, while applying adequate scrutiny and regularly updated risk-based pricing to new lending decisions.

– As part of this, maintain focus on high quality loan origination. This includes addressing the historic shortcomings in credit pricing identified by the ECB's pre-COVID review of underwriting standards, and implementing the requirements of the EBA's new guidelines on loan origination and monitoring.

– Review NPL recovery strategies in the light of evolving conditions, including the possible use of 'bad banks' and 'good banks' to distinguish between different lending portfolios, helping to maintain stability.

– Take steps to prepare for asset quality reviews by European banking authorities, and the increased likelihood of other periodical and ad-hoc credit reporting to supervisors. The industry will be challenged with more stringent stress tests in 2021, including adverse scenarios featuring higher default rates than before, with corresponding impacts on regulatory capital.

– Understand and anticipate the potential hit to capital and profitability when regulatory relief, public guarantees and payment holidays are withdrawn. These cliff effects could become more serious the longer that moratoria continue, meaning that banks would benefit from the ability to quickly simulate such anticipated future situations.

– Maintain their focus on the IRB repair programme. This now includes deciding when to feed historical time series reflecting the COVID-19 pandemic into IRB models. The impact on models will be felt from 2021 onwards, when regular validations might reveal problems. Effective data management will be crucial to achieving valuable model outputs. This includes the accurate identification and management of COVID-19 related data and the proper treatment of default data, adjusted as required for the effects of pandemic relief measures.

– Perform IFRS 9 model recalibration in the light of COVID-19. The historic relationships between economic conditions, customer behaviour and ECL parameters such as loss rates, PDs and LGDs in existing ECL models are now outdated. COVID-19 means that existing ECL models can no longer be relied on to make accurate predictions. Model recalibration will also need to reflect the new EBA definition of default, which is effective from January 2021 in the EU and January 2022 in the UK.

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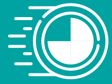

Long term

Finally, in the longer-term we believe that banks should give thought to how they can integrate a revised approach to credit risk into their wider strategic efforts to address fundamental weaknesses in the industry, for example:

- Support efforts to reduce costs, increase efficiency and improve customer experiences by digitising credit processes. This will help to make the entire credit lifecycle more efficient, flexible and data-driven. Key elements might include digitising and enhancing the quality of existing data, the harnessing of new risk indicators, the systematic analysis of information, and the application of insight to credit decisions. Digitisation could also enhance Suptech's potential to make supervision more efficient, effective and forward-looking.
- Rethink internal organisation and governance frameworks, allowing for faster adaptations to volatile credit conditions. Credit risk appetites should ideally be fully aligned with banks' capital planning and dividend policies, and carefully communicated to supervisors and investors.
- Gauge credit strategies against the possibilities for greater structural efficiencies that could result from consolidation between banks. The ECB has recently published a draft guide setting out its approach to banking consolidation, with a view to increasing systemic resilience. Greater concentration could boost economies of scale and reduce overcapacity, strengthening bank profitability. It could also facilitate investment in digital transformation and enhance banks' ability to finance the economic transition to a post-COVID-19 world.

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Summary

The COVID-19 crisis is creating the most severe credit downturn since the creation of the Eurosystem. In the short to medium term banks can expect economic weakness, the withdrawal of payment moratoria and the effects of IFRS 9 and credit model parameters to drive up NPLs and impairments. It is too soon to predict the full credit implications of the pandemic.

The credit downturn will have a significant impact on banking profitability and capital. Given the vital importance of bank lending to the wider economy, managing credit risks as intelligently as possible is likely to be a multi-year priority for banks and supervisors alike.

Banks are already taking a wide range of actions in response to the crisis, but face numerous challenges in areas including NPL management, loan underwriting, provisioning, credit risk modelling and credit governance. They also need to respond to supervisors' heightened scrutiny of asset quality and credit risk - themes that are central to the 2020 SREP, the stress tests of 2021 and all supervisory activity over the coming months. Close communication and cooperation between banks, regulators and supervisors will be crucial to recalibrating the management of credit risk for a post-COVID world.

Looking further ahead, effective governance and prioritisation will help banks to begin preparing for the future while managing the effects of the crisis. In the long term, developing a more intelligent and flexible approach to credit risks will allow banks to integrate credit appetites into strategies such as digitisation and consolidation, creating a more resilient banking system and helping the wider world to 'build back better'.

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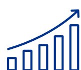
How KPMG can help

As part of a global organisation, KPMG specialists have indepth experience across the spectrum of credit risk, including model development and validation. KPMG firms can help to identify rating model deficiencies, providing understanding about effectiveness and impact of a disruptive crisis situation.

KPMG firms can assist in the application of COVID-19 scenarios and simulation of creditworthiness in the credit portfolio with deep credit risk analytical expertise in rating development and stress test modelling.

Leveraging advanced data analysis techniques, KPMG specialists can support in identifying relevant earning warning signals and enhancing the overall credit worthiness assessment process.

KPMG professionals can help develop realistic NPE strategies, divestment plans and realisation options for portfolio optimisation. KPMG firms can support the development and implementation of sound restructuring strategies and workout plans for NPEs, improvement of loan collection processes, restructuring and workout support for complex exposures.



KPMG credit risk regulatory and accounting specialists are providing regulatory interpretation support, as well as expertise regarding IFRS 9 requirement and its interaction with regulatory guidance. The support involves the review and interpretation of specific rules to provide clear and coherent guidance on how the bank can meet the regulatory CRR requirements and IFRS 9 standards, especially in times with plenty supervisory amendments and relief measures.

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Annex

Abbreviations	Meaning
BCBS	Basel Committee on Banking Supervision
CCB	Capital Conservation Buffer
CCFs	Credit Conversion Factor
CET1	Common Equity Tier 1
CRR	Capital Requirements Regulation
CRR2	Capital Requirements Regulation 2
EBA	European Banking Authority
ECB	European Central Bank
ECL	Expected Credit Loss
ESG	Environmental, Social and Governance
EU	European Union
GDP	Gross Domestic Product
HHs	Households
IFRS	International Financial Reporting Standards
IRB	Internal Ratings-based
LGD	Loss Given Default
NFCs	Non-Financial Corporations
NPLs	Non-performing loans
P2G	Pillar 2 Guidance
PDs	Probability of Default
RWA	Risk-Weighted Asset
SME	Small and Medium-sized Enterprises
SREP	Supervisory Review and Evaluation Process
Suptech	Supervisory Technology
TA	Transitional Arrangements
TRIM	Targeted Review of Internal Models

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