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The regulatory response to the Covid-19 crisis: a test for post GFC reforms

Check Against Delivery
Seul le texte prononcé fait foi
Es gilt das gesprochene Wort

Introduction

Ladies and Gentlemen,

I would like to thank the Italian Banking Association for having me today and the opportunity to discuss with you our regulatory response to the pandemic crisis.

2020 has been quite a challenging year. The unprecedented circumstances we are confronted with have been compared to wartime. I do not know whether this is the case – we have been lucky enough to have experienced a long period of peace in Europe – but the spread of coronavirus has indeed determined pain, fear and uncertainty.

In the past few months, our limits as organisations, professionals and individuals have been tested. We have gradually adapted to the new conditions and, now, know better how to mitigate the risks compared to the beginning of the pandemic. Still, many challenges lie ahead of us. This is true for our health systems, our economies as well as the banking sector.

The exceptional measures in response to the health crisis have brought the global economic activity to a sudden freeze. Because of the various forms of population confinement – such as widespread lockdowns and social distancing – the Gross Domestic Product (GDP) declined markedly in the first half of 2020 and its perspective remains uncertain in the EU and at the global level.

Of course, the magnitude of the impact of COVID-19 in the coming quarters largely depends on how successful we will be in limiting contagion and preventing further waves. The effectiveness of

the actions taken to support the economy will also determine the pace of the recovery of our economies.

Banks have an important role to play in supporting the economy and its recovery. EU supervisory authorities have demonstrated an unprecedented capacity to act quickly, resolutely, and effectively to mitigate the impact of the crisis on the financial sector. The EBA, in close cooperation with the other European Supervisory Authorities, the ECB-Banking Supervision and the national authorities, took a number of steps to allow banks to maintain their support to households and corporates at this very difficult juncture.

Today, in my remarks I will summarise the actions taken as an immediate response to the crisis, provide some initial thoughts on the lessons learnt and try to look forward and sketch some possible implications for future policy-making.

The eruption of the crisis and its impact on the banking sector

European banks entered the COVID-19 epidemics in a better shape than they did in previous crises, with larger capital levels and abundant liquidity buffers.

In December 2019, EU banks' Common Equity Tier 1 ratio (CET1) was about 15% and it remained stable in the following quarters. The management buffer – which is the additional capital banks hold in excess of capital requirements, buffers and supervisory expectations – was around 300bps of RWAs. The release of macroprudential and other supervisory buffers have provided additional breathing space for banks. However, data also shows that capital buffers were not necessarily available where mostly needed, because of the diverse implementation of macroprudential measures across Europe.

Similarly, liquidity buffers were ample, with the Liquidity Coverage Ratio close to 150%. Banks' funding mix was also more balanced and stable, with a steady increase of the share of household and non-financial corporation deposits since the Great Financial Crisis (GFC). Banks also benefited from favourable conditions in wholesale funding markets in the last few quarters before the outbreak of COVID-19, and in early 2020 had already managed to frontload part of their issuances before primary markets came to a temporary halt at the start of the crisis.

The strong capitalisation and liquidity profile of the banks, coupled with the decisive response of the regulators and supervisors to support the banking sector, have enabled European banks to cope with the immediate impact of the crisis, while supporting their customers and governments' efforts to push liquidity in the system.

On the operational side, the digitalisation efforts and relevant investments of the past few years have proved helpful to deal with a sudden move to remote working. Banks have actually demonstrated operational resilience and an ability to operate largely with remote staff and small physical presence, even in core business areas.

Notwithstanding the progress, there are vulnerabilities in the EU banking sector that are likely to be exacerbated by the pandemics. They are the legacy of the Great Financial Crisis but are also determined by the lack of systematic structural reforms afterwards.

We need to acknowledge the efforts banks put in repairing their balance sheets and improve asset quality. Banks are without doubt in a better place today than they were just a few years ago. The non-performing loan (NPL) volume and ratio more than halved since 2014. However, with hindsight, the pace of adjustment could have been faster. Despite the continuous improvement, NPL ratios in several countries remain above pre-2008 levels and are expected to increase as a result of the recession.

According to a sensitivity analysis we carried out for assessing the impact of COVID-19 on EU banks, stage 3 assets could increase to levels comparable to 2014 and credit risk losses could determine a decline of CET1 ratios between -230bps to -380bps1.

While we are cautious in interpreting these results given the uncertainty on future economic conditions and the mitigating impact of the ponderous government support measures, this is an area that requires close monitoring, proactive actions and, I believe, an enhanced policy toolkit. Asset management companies can be an effective way to transfer non-performing assets out of the banking sector and, while they are often associated to state-aid and resolution rules, they have a broader role to play particularly in case of a widespread deterioration of credit quality.

My second concern is profitability, which has never recovered since the last crisis. Profitability levels have remained subdued amidst low interest margins and banks' significant challenges in reducing operating expenses. For many banks, the return on equity does not even cover the cost of equity, as also reflected in extremely low market valuations. Pressure on interest margins will not dissolve anytime soon, as the low or negative interest rate environment is expected to persist for even longer.

The regulatory response

The response of the regulatory and supervisory authorities was remarkably swift, making their reaction more effective from the outset.

First, regulators provided operational relief to the banks, allowing them to shift resources where they were mostly needed. This was a decision we did not take lightly. Postponing the EU-wide stress test exercise by one year, delaying remittance dates for supervisory reporting and putting on hold consultation processes determined a loss of valuable information, in particular on banks' latest conditions, at the very moment we actually needed it the most. Nevertheless, this was the right thing to do in exceptional circumstances, with banks in great need to focus on critical functions and operational continuity.

[1] EBA (2020), Thematic note, The EU Banking Sector: First insights into the COVID-19 impacts.

We also provided some operational relief to institutions in the context of recovery planning, where we allowed them to submit to the competent authorities only key elements of their recovery plans in 2020, with the possibility to postpone the submission of other parts of the plans until the following assessment cycle.

On the other hand, taking into account the critical importance of banks' digital operations, we underlined the importance of complying with the EBA guidelines on ICT and security risk, but also encouraged supervisors to apply reasonable supervisory flexibility when assessing the implementation of these guidelines and to focus on information security, ICT operations and business continuity management.

Second, the EBA reminded that the capital accumulated by banks was there to be used not only to absorb losses but also to ensure continued lending to the economy and encouraged competent authorities to use the flexibility embedded in the existing regulatory framework. In the same spirit, several macroprudential authorities released the countercyclical buffers and supervisors allowed banks to operate below their Pillar 2 Guidance (P2G).

The obvious corollary was, however, for banks to follow prudent dividend and other distribution policies. The generalised ban to dividend payments that some authorities imposed in connection with the EBA's recommendation allowed banks to strengthen their capital base with an overall impact of about 40 bn Euros.

This was a controversial measure, and a few stakeholders have argued against it, criticising a blanket ban rather than case-by-case decisions. However, a system-wide approach was proportionate to the severity of the crisis and the uncertainty on its effects. A case-by-case approach would have not achieved the same objective and the stigma effect on some banks could have adversely affected some borrowers in more urgent need of support.

Capital-related measures had the objective of enhancing banks' ability to finance the economy, creating additional headroom for lending. Taken together, these measures freed up extra capital of roughly 110 bps, with the management buffer increasing on average to roughly 500 bps of RWAs, assuming the full use of P2G.

In addition to capital measures, we also supported the view that liquidity coverage ratio is designed to be used by banks and recommended supervisors to avoid any measures that may lead to the fragmentation of funding markets.

Beyond actions on capital and liquidity, we felt the pressing need to address the prudential treatment of legislative and non-legislative payment moratoria, which were introduced by several countries as a support measure to provide the necessary breathing space to borrowers. After providing early information on their implications for credit risk recognition, we fast-tracked guidelines on moratoria, perhaps the fastest ever publication of guidelines by a European agency.

The guidelines clarify that the payment moratoria do not trigger forbearance classification and the assessment of distressed restructuring if they are based on the applicable national law or on an

industry-wide initiative agreed and applied broadly by relevant credit institutions. These guidelines were necessary for avoiding the automatic reclassification in forborne or defaulted status of loans under moratoria, but they also confirmed the necessity to ensure that the risk is identified and measured in a timely and accurate manner. They safeguard borrowers with temporary liquidity problems due to Covid-19, but do require the assessment of the long-term unlikeliness to pay.

The initial deadline for eligible moratoria was 30 June 2019, but it was subsequently extended to 30 September in order to grant obligors longer time to decide to apply for a change in their payment schedule without being classified as defaulted or considered as forborne. This extension was agreed taking into account that Covid-19 had been affecting EU countries in a different way and pace.

As we are now approaching this deadline, we are moving back to a normalisation of the situation. This in no way takes away the possibility for a bank to grant payment extensions where appropriate, but these should follow the regular rules. The normalisation targets two elements. Firstly, it provides clarity to banks about the need to look at credit indicators going forward. Secondly, it assures that proper risk assessment continues, avoiding the risk of unrecognised NPL build-up, as we saw in the last crisis and ensuring that risk metrics are well trusted. Furthermore, for those customers who have already been granted payment moratoria, it will not automatically trigger a reclassification, thereby preventing a cliff effect on reclassifications or credit flows.

We also provided regulatory guidance regarding the IFRS9 treatment and recommended supervisory measures to soften the potential impact of market turmoil, for instance on capital requirements stemming from exceptional volatility.

At a time when banks and supervisors were dealing with significant operational challenges, we also recognised the need for a pragmatic approach in the 2020 Supervisory Review and Evaluation Process (SREP), and recommended that competent authorities focus on the most material risks and vulnerabilities driven by the crisis.

The rationale of the package of measures we adopted is clear. We wanted to safeguard business continuity in the sector, allow banks to use the capital and liquidity buffers accumulated over time, and remove any unintended obstacle to the widespread use of public support measures.

The emergency determined by Covid-19 called for emergency measures. However, it was – and it is – important to preserve the correct measurement of risks and the reliability and timeliness of risk metrics. Therefore, we also put in place adequate tools in order to enable supervisors and stakeholders to monitor these exposures and adequately assess the evolving situation in the banking sector. The EBA introduced ad-hoc reporting and disclosure requirements for the exposures benefitting from moratoria and public guarantees. This will allow supervisors to understand the materiality of the exposures, as well as their classification for prudential and accounting purposes.

Lessons learnt

We are still in the midst of the crisis. However, I would like to share with you some thoughts on what we have learnt so far.

All crises are different but they all share a common outcome. National authorities tend to react looking primarily within their borders. This is understandable when there is an urgency to act under time pressure and uncertainty, but it is far from optimal and can jeopardise the level playing field.

This crisis makes no difference, with payment moratoria and public guarantee schemes launched with little or no coordination, different deadlines, coverage and conditionality. With our guidelines, we tried to provide a harmonised framework for the prudential treatment of such measures, which, however, remain different in many aspects. I believe we should do better in the future in order to preserve the Single Market.

On the positive side, I think that the regulatory reforms agreed at the global level in the aftermath of the GFC have been successful in ensuring that banks entered the crisis in a relatively strong position compared to previous crises. Should the pandemic have hit the banking sector as it was in 2009 or even in 2014, we would not be discussing how banks can contribute to the recovery, but how to avoid the collapse of the sector.

High capital, ample liquidity, improved asset quality, enhanced digital capacity, stronger risk management helped banks to respond to the emergency. This confirms the importance of a sound regulatory framework and its effective implementation. It also shows the benefits of adhering loyally to international standards.

Authorities have also proved to be up to the challenge and willing to make full use of the countercyclical element embedded in the Basel 3 framework. Since the outset of the crisis, micro- and macro-prudential, European and national authorities provided the unequivocal message that capital is there to be used. Relaxing capital requirements and encouraging banks to make use of their liquidity buffers in a crisis do not come natural to supervisors, but they are key to allow the banking sector to act as a stabiliser rather than an amplifier of the shocks. This was the very purpose of including a macroprudential perspective in the prudential standards.

However, banks seem to be unwilling to use the released buffers and indeed, until the second quarter of 2020, there is no sign of CET1 ratio decline, at least on average at the EU level. It is important to understand why this is the case.

On the one hand, there could be a general concern related to the market stigma associated with the use of buffers or even with the simple decline of capital ratios. This would indicate the reluctance of market participants to accept fluctuations of buffers as a normal – cyclical – event they should not be worried about.

On the other hand, the scarce usability of the buffers can be linked to the way they work. In the prudential framework, some buffers – e.g., the countercyclical capital buffer (CCyB) – are inherently

countercyclical since authorities can activate and deactivate the requirement depending on the evolution of economic conditions. Other buffers – e.g., the capital conservation buffer – are, instead, structural and work as an automatic stabiliser since banks failing to meet the requirement are automatically subject to capital conservation measures.

Banks can be hesitant to use the structural buffer since this may undermine their ability to payout dividends and coupons if they are at risk of breaching the overall capital requirements and, thus, triggering maximum distributable amount rules. If so, we should consider whether countercyclical, releasable buffers are superior at least in terms of usability in rainy days. This can also call for a recalibration of the buffer structure, with a greater role for buffers that can be switched off by the authorities. On the other hand, since countercyclical buffers have been built up only in a limited number of jurisdictions and to relatively limited levels, the question is whether we should also harmonise the way these buffers are deployed, pushing for a faster and larger accumulation in good times.

Conclusions

The crisis triggered by the COVID-19 pandemic put the post GFC reforms to test, a real-life stress test of the system. With the evolution of the pandemic still unclear and uncertainty on its short- and long-term economic consequences, it would be unwise to draw conclusions.

Still, my overall impression is that the philosophy behind the post-GFC regulation – more demanding requirements in normal times that can be relaxed in bad times – has been successful. This does not mean that there are not some aspects of the existing framework requiring a critical review. Changes may be necessary, but I see this as a fine-tuning and calibration of the framework rather than a fundamental rethinking of it.

I would also advocate taking enough time to reflect, discuss and make decisions. Changing the rules while the crisis is ongoing would be premature, imprudent and could be interpreted as a signal of weakness of the banking sector, at a time markets are volatile and investors nervous. Once the health crisis is – hopefully – under control and the emergency over, it will be natural to make a stock-take of the elements that have worked well and those deserving some adjustments.

The EU banking sector has been resilient so far but there are challenges ahead. Notwithstanding unparalleled fiscal, monetary and supervisory measures deployed by EU and national authorities, the economic crisis will hit the sector hard, particularly in terms of deterioration of credit quality and profitability. The 2021 EU-wide stress test will allow us to better assess the consequences of the crisis on banks, start discussing plausible exit strategies, and set supervisory expectations on capital planning.

Our analyses show that the sector is overall resilient, but banks that entered the crisis with lower capital levels, poor business models and riskier exposures may face challenges. In addition, second waves of contagion and a delayed economic recovery could further weaken the banking sector.

Deteriorating asset quality and the ‘lower for longer’ interest rate environment are expected to weigh on an already subdued profitability.

Digitalisation and the use of ICT is further progressing in the crisis and this could be a game-changer for banks. It could bring costs down and allow them to move towards more sustainable business models, but this should go together with careful management of ICT risks.

Pre-existing elements of weakness in the banking sector must not exacerbate the crisis. The need to address overcapacity and advance with banking sector consolidation will become ever more important and supervisors are supporting measures to facilitate such process. A coherent and consistent application of the European resolution framework will be important where banks may become non-viable in the crisis. Although the challenges ahead are huge, the crisis offers the chance for the banking sector to emerge stronger, more efficient and innovative.