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Keynote speech by Jose Manuel Campa

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The implementation of Basel 3 in the post-Covid 19 setting

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

Ladies and Gentlemen,

Thank you for allowing me to speak here today. Before I start, let me first thank ISDA for its constructive collaboration over the years. As I am sure you all know, while I think the principles behind banking regulation tend to be simple, the regulation in itself can be (bloody) difficult and requires significant technical expertise. It is therefore important that we can have the high level discussions, which we are having here today, but I also appreciate the more technical contributions and exchanges with ISDA staff, for instance in the area of FRTB implementation. These exchanges, both today, but also at the more technical level, create a better understanding on the objectives and challenges that both banking regulators and the industry have in common – even though we may not always agree.

Today, I want to talk about three things. Firstly, a look back on the measures taken in relation with COVID-19. Secondly, I want to talk about the Basel III implementation, where I see a loyal and swift implementation of Basel III in the EU as desirable. Finally, I want to talk more broadly about what I see as needed to support the recovery after COVID-19. In particular how banks, supervisors and regulators can play a key role in both managing the risks of NPL losses, but also highlight that we have a responsibility to ensure that the

corporate restructuring of firms hit by COVID-19 is done in a proper manner to ensure a sound recovery.

The COVID-19 pandemic

In the first phase of the pandemic, the focus was on maintaining banks’ ability to provide lending and prevent liquidity shortages faced by European businesses and households. At EBA we promoted that the flexibility embedded in the prudential framework should be used for this purpose, with the prompt publication of the guidelines on payment moratoria, on 2 April 2020, as one of the best examples. Payment moratoria have been an effective tool to address short-term liquidity shortages caused by the limited or suspended operation of many businesses.

We are now at a different stage in the crisis, and after more than a year of crisis conditions, banks executives and supervisors focus should be on the consequences of the crisis on banks’ lending books and activity going forward. Focus is therefore shifting towards a need to **return to normality** to ensure the robustness, but also the credibility, of the banking sector. That being said, from an EBA perspective, we also recognize the need to have **robust monitoring** in place, such that we can act quickly, should the need arise. There is still uncertainty, although the outlook is clearly improving with vaccine programs being rolled out, we are still not out of the woods.

On the return to normality, the focus should in particular shift to allow a proper recognition of the consequences of the pandemic on banks’ lending books and manage the transition towards the recovery phase.

Several arguments support this view. First, the resilience of the banks to the pandemic, show us the importance to adhere to the prudential framework in order to ensure sufficient buffers are available for “rainy days" – these buffers also contributed to the banking sector being able to play a constructive role in supporting the COVID-19 pandemic. Secondly, enforcing the existing rules on provisioning and on capital requirements are needed – both from regulators, but also for investors - to assure banks provide an accurate picture of the risks they face. Thirdly, a number of exceptional support measures have been enacted and provided relief to obligors and banks, thus reducing the impact of the crisis and potential negative effects from excessive pro-cyclicality.

The exceptional measures put in place and the health and economic challenges that are still confronting us imply that a strong need for **monitoring** of banks’ asset quality has emerged. The latter should be the basis to coordinate the unwinding of the various support measures implemented. At EBA, regular monitoring of indicators of bank’s asset quality has always been part of the supervisor’s work, also in the context of the unfolding of the COVID-

19 pandemic. In addition, we have established COVID-19 reporting to ensure that the new elements of risks are being monitored. In particular, I would highlight the EBA 2021 Stress Test as part of our monitoring efforts, which aims to shed more light on banks' health and will provide supervisory guidance in light of expected credit deterioration.

Our monitoring efforts until now have showed us that capital relief measures have strongly supported the build-up of banks' capital buffers. The buffers can be used by banks for covering losses, and provide new lending. Profitability, which was already subdued before COVID-19 due to low margins and a rigid cost base, has however further declined, mainly due to increased impairments. The share of stage 2 loans further increased in Dec 2020 to 9.1% (Dec 2019: 6.5%) and could be the prelude for a future rise in NPLs. Moreover, both the share of stage 2 loans as well as cost of risk show a wide dispersion among banks and countries. Therefore, I would simply note that some caution is still warranted. While banks are robust today and have constructively played a part in continued lending through the pandemic, which helped support the economy, banks are still facing many risks and we will at EBA continue to monitor the developments closely, especially, as mentioned, in the 2021 stress test.

Basel III

Looking a bit more ahead, the natural question to ask, is whether the COVID-19 pandemic should impact the regulatory agenda that was set before the crisis, and in particular the implementation of final Basel III standard. My view is that this pandemic is a reminder of the importance of a high quality regulatory framework for a robust EU banking sector and that the bulk of the measures implemented post the GFC, of which Basle III is the most visible, have proven useful in managing through this crisis.

I believe this is an opinion broadly shared at the EBA and more broadly by all regulators worldwide, and I recall that the Group of Central Bank Governors and Heads of Supervision (GHOS), the oversight body of the Basel Committee on Banking Supervision has reiterated unanimously their expectation for the full, timely and consistent implementation of all aspects of the Basel III framework.[1] In short, while we recognise that the COVID-19 pandemic has required the need for exceptional measures, the structural nature of the Basel III reforms will still be needed.

The Basel III **framework increases the risk sensitivity of the standardised approaches** and **limits the ability to model** in areas, where variability has been known to exist, that is, for those models, where few loss observations exist, which makes the use of IRB estimation

[1] https://www.bis.org/press/p201130.htm Governors and Heads of Supervision commit to ongoing coordinated approach to mitigate Covid-19 risks to the global banking system and endorse future direction of Basel Committee work

methods less reliable. These are structural aspects of the reform, which overall leads to an improvement. To me, it strikes the correct balance between maintaining a risk based framework and the necessary constraints to restore trust in global standards. In fact, this is an area where the **credibility of EU**, but also the Basel Committee, is at stake and we consider it of utmost importance that EU continue to be perceived as a key-player in the setting of financial regulations. Keeping our goal to preserve a global level playing field and to avoid regulatory fragmentation should be a key principle as we approach the final implementation of the reform.

I would like to insist on five general principles underlying the main recommendations for the implementation of this reform in the EU:

- Firstly, it is important to ensure that EU implements the reform in full, and avoid any material deviation. Should we instead choose to deviate substantially from Basel, we risk undermining the overall global framework and weakening the effectiveness of working towards common global standards at the Basle table.

- Secondly, continued international co-ordination is necessary to ensure full implementation by all jurisdictions and global level playing field. Deviating in the long-term would risk fragmenting the rules underpinning the global financial system. Differences in the rules across jurisdictions would likely trigger a regulatory race to the bottom, which is not a prudentially sound outcome and will certainly backfire in the event of another financial crisis.

- Thirdly, the reforms will introduce more risk-sensitivity in the framework and the output floor will serve as a backstop to internal models. This is incorporating the lessons from the financial crisis and structurally improves the overall framework.

- Fourthly, to achieve the benefits of the reform smoothly, I think the role of the EU banking industry is of particular importance – banks are to indeed be ready for the upcoming changes. Initiatives on the industry side, like the ISDA benchmarking exercise, supporting banks in implementing consistently the new market, counterparty and CVA risk regulatory approaches are in my view positive, as they go in the direction of getting banks prepared for the new framework.

- Finally, the reform should come with a recalibration of existing overall capital requirements in the EU to take into account enhancements from the Basel III reform. While this will remain a case-by-case decision, competent authorities and authorities in charge of macroprudential requirements should take due account of the new requirements (including the impact of the output floor) and avoid overlap

in objectives between the Pillar 1 rules established by Basel and other measures such as Pillar 2 and systemic risk buffer.

While I mentioned the structural benefit of the reform, one could argue that the COVID-19 pandemic has weakened the banking system, making it more difficult to cope with the transitional costs of new framework and therefore potentially hurting the economic recovery. I do not share this point of view. I would in particular highlight, that the new framework will be completed only in 2028 in line with the Basel calendar – hence, its implementation entails a limited impact on any COVID-19 supporting measure.

Indeed, we performed an update of the quantitative impact of implementing the Basel reform in December 2020.[2] In accordance with this EBA latest estimate, banks will face an overall increase of Tier 1 capital requirements by around 18%, reduced to around 13% if existing EU exemptions are kept. This shows a significant reduction, if compared against the estimates provided by EBA in 2019, signaling the efforts that banks are already taking to comply with the Basel III rules in the future. We also recall that the new set of standards is meant to address the drawbacks of the previous framework and does not impact all banks with the same magnitude. Hence, the level of increase in capital is commensurate to the flaws that are addressed, and will be negligible, or even negative, for some EU banks. Moreover, as previously explained, results show that banks are already making efforts to improve the capital positions and fulfill the Basel III requirements. There are reasons to believe that banks will be able to reduce significantly the capital shortfalls via the generation of profits as shown in our first impact assessment

Furthermore, I should stress, that the analysis of the macroeconomic impact of the reform clearly shows that the introduction of Basel III may come with modest transitional costs, but will result in lasting gains, due to a more robust financial sector that will contribute to attenuate future economic downturns – resulting in an overall macroeconomic gain of implementing the reforms.

Helping the COVID-19 recovery

Let me move on and make some considerations on what are some of the challenges that in my view we should consider in the aftermath of COVID-19. In general, I would highlight that I see important trends in the medium term , including the digitalisation of the economy and the need to move towards a sustainable economy, which are each of them a topic itself for another speech. Today, I would however like to focus on the shorter term and the need for corporate restructuring in the wake of COVID-19 and highlight the impact this may have on risk in banks balance sheets and the role banks will have to play.

[2] https://www.eba.europa.eu/eba-updates-its-basel-iii-impact-study-following-eu-commission%E2%80%99s-call-advice

As the payment moratoria and other public support measures start to expire, banks and borrowers experiencing financial difficulties should proactively work together in finding the most appropriate solutions for their circumstances, done in a respectful way for consumers and businesses. That should include not only financial restructuring, where banks have experience and internal capacity, but also to the extent possible operational restructuring (for SME and corporate loans), aimed at restoring the viability of such borrowers. Such restructuring businesses may require different or additional financing means other than bank lending. In particular, some firms will find themselves overleveraged and more equity type financing could be more appropriate for them. Banks role of acting as an intermediary will remain important, such that firms can receive the necessary capital injections, based on banks helping to support them in attracting new/additional investors. Further developments in financial markets and towards a capital market union should also help in this process. I view the capital markets union agenda as more salient to ensure a strong and robust recovery.

This process has to take into account the significant role of public guarantees in the management of the COVID crisis. The existence of these guarantees has significantly affected banks balance sheets. Not surprisingly the risk weights on loans under public guarantees are a third of the risk weights on normal loans to non-financial corporations, i.e. 18% RW vs 54%. Given the large amounts of loans under public guarantees, over €330 billion at the end of 2020, this has the positive effect of reducing risks in the banking sector and has undoubtedly contributed positively to continued support for struggling businesses and consumers. It is also clear that this government support will have to play a role in ensuring the effective restructuring of those non-financial corporations.

Preserving the single market, a level playing field and adequate transparency becomes more important in this process as the public guarantee schemes are national in nature and differ substantially among them in many details. Additionally, as documented in a recently (November 2020) published report by EBA, there is still significant variability across Member States in the effectiveness of national insolvency practices as measured by recovery rates, times of recovery and costs of recovery. The interaction of these new features in the public guarantee schemes with the specifities of national insolvency procedures may result in inefficient corporate restructurings or disruptions to the single market and an efficient allocation of lending and capital across the EU.

Regulators and public authorities need to support banks' efforts in managing loan restructuring (forbearance) as well as inflows of non-performing loans post COVID-19. At the EBA, we are collectively working with other authorities under the comprehensive Commission action plan from December last year, where the EBA is playing an important role in improving data standardisation in facilitating sales of NPLs and the functioning of

the secondary markets for NPLs, looking at the regulatory treatment of sold defaulted assets, as well as contributed to building framework for more effective and efficient securitisation of NPLs – all to help banks better prepare as part of their NPL management strategies in the aftermath of the COVID-19 pandemic.

To conclude, I therefore see the banking industry as continuing to have an important role in supporting the recovery. The key challenge from a macroeconomic perspective will be to help a sound recovery by facilitating the restructuring of firms affected by the crisis in a viable and sustainable manner. The role of the banking sector is crucial in this regard, by relying on sound credit judgements and adequate lending. Viable firms must be allowed to continue. However, there will also be some firms, who will no longer be viable. Making the distinction between viable and non-viable firms will be a difficult balance and the financial industry should be ready to provide its expertise to facilitate this task.

Thank you!