EUROPEAN BANKING AUTHORITY

BCBS-BSCEE-FSI Europe High-level meeting on banking supervision

Videoconference – 6 May 2021

Reflections on our regulatory response to Coronavirus and our future priorities

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

Ladies and Gentlemen,

I would like to thank the Basel Committee on Banking Supervision (BCBS), the Group of Banking Supervisors from Central and Eastern Europe (BSCEE) and the Financial Stability Institute (FSI) of the Bank for International Settlements (BIS) for having me today and for giving me the opportunity to open a reflection on how we have responded to this major health crisis and on what should be banks' priorities in the new normal.

Let me first start with some important considerations on how banks have handled the pandemic so far. It is clear that the European banking sector has entered this major crisis well capitalised in aggregate terms and thereby better prepared to withstand a challenging macro environment. As we all know, this time, banks were not the source of the crisis, nor have they been the most affected sector. In addition, thanks to their strong starting positions and unprecedented public measures to support the economy, banks proved able to absorb the initial shock, remain resilient, and provide liquidity to struggling households and firms.

Public authorities, monetary, fiscal, and regulatory authorities have also played a key role by acting quickly, resolutely, and effectively to mitigate the impact of the crisis on the financial sector. At the European Banking Authority (EBA), we have taken a number of steps, first, to facilitate banks to continue providing financing to households and corporates at a very difficult juncture and, second, to monitor the evolution of the crisis in order to adjust its measures as deemed necessary.

However, as the pandemic continues to affect the economy, a legitimate question arises of whether banks will be able to absorb the full impact of the crisis as they continue providing adequate lending to the economy, and whether the regulatory framework is fit for purpose to allow banks to pursue these goals.

The outbreak of the Covid-19 pandemic was indeed an unprecedented test for the economy and made any forecasts outdated and obsolete. Organisations, professionals and individuals have gradually adapted to the new working conditions and learnt how to mitigate the operational difficulties and emerging risks of a worldwide pandemic. Yet, with the vaccination campaigns progressing at uneven pace in different jurisdictions and widespread uncertainty on the start and speed of economic recovery, many challenges lie ahead. This is true for the health systems, the economies as well as the banking sector.

Against these considerations, I would like first to elaborate more on the responses taken so far to mitigate the crisis – with a particular focus on the EBA’s response - and then conclude on the outstanding challenges to return to a new normal.

Regulatory Response to COVID-19

The immediate reaction of the supervisory community to Covid-19 and the gradual deployment of containment measures by governments aimed at ensuring business continuity in such difficult circumstances. It was important that banks were able to serve the economy and their customers, avoiding the collapse of credit to the real economy at the very moment when it was required to transmit fiscal stimulus to corporates and households.

Regulators provided operational relief to banks, allowing them to shift resources where mostly needed. This decision was not made lightly. Postponing the ongoing 2020 EBA 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 authorities 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 resilience.

At the global level, as we all know, the implementation of the Basel 3 standards finalised in December 2017 was deferred by one year to January 2023. In Europe, the EBA recognised the need for a pragmatic approach in the 2020 Supervisory Review and Evaluation Process (SREP) as well as for recovery planning, and recommended that supervisory authorities focus their efforts on the most material risks and vulnerabilities driven by the crisis. It also reminded that capital – and liquidity – buffers accumulated by banks over time were a reserve to absorb losses but also to ensure continued lending to the economy. In the same spirit, several macroprudential authorities released the countercyclical buffers and supervisors allowed banks to operate below their Pillar 2 Guidance (P2G). It was also clarified that part of the Pillar 2 requirements could be covered with instruments other than CET1.

Taken together, these measures contributed to free up capital which in addition to the capital preservation measures implemented by the banks themselves, has resulted in an increase of the management buffer from 300 bps in December 2019 to 570 bps by the end of last year, assuming the full use of P2G. However, the availability of buffers was uneven across the EU due to the different starting position of banks and the diverse implementation of macroprudential measures across Europe.

The EBA also intervened to avoid any unintended reclassification in default status for debtors in temporary liquidity difficulties. In particular, there was a 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 payment breaks to borrowers. The EBA published guidelines[1] to clarify that the payment moratoria do not automatically 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 of a timely and accurate measurement of credit risk. They safeguarded borrowers with temporary liquidity problems, but did require the assessment of the long-term unlikeliness to pay.

At the same time, adequate tools were needed 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 allows supervisors to understand the materiality of the exposures as well as their classification for prudential and accounting purposes.

Authorities have been also proactive in triggering the countercyclical features embedded in the Basel 3 framework. Since the onset of the crisis, micro- and macroprudential, 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.

The focus has been so far on making sure that existing capital buffers were there to be used and support the economy. The evidence suggests that so far those buffers have not been needed in a widespread form. Banks capital ratios (and liquidity ratios) have continued to increase through the second half of last year. This has been partially thanks to the large and unequal monetary and fiscal measures put in place that have shielded the banking

[1] EBA (2020), Guidelines on legislative and non-legislative moratoria on loan repayments applied in light of the COVID-19 crisis.

sector by a large proportion of the negative economic shock. Regulatory measures providing capital relief have also helped. However, it is also true that banks are reluctant to use some of these buffers. The complexity of the regulatory system on the usability of the different buffers, their interaction and the implications for pursuing the bank strategy makes it harder for bank management and investors to adequately plan a bank capital trajectory. Banks concerns over possible negative stigma if buffers are used, supervisor reactions or ability to rebuild the buffers with sufficient time are often mentioned. The crises has shown that authorities and bankers perspectives on the usability of such buffers were far apart and we need to work to ensure a regulatory framework that provides more clarity and brings those different views by the public and private sector closer to a more common understanding.

Banking Sector Challenges Going Forward

Looking forward, and in view of a return to a new normal, banks need in the short run to withstand the likely increase of credit risk losses and maintain adequate lending volumes, particularly when moratoria, public guarantee schemes and other support measures expire.

There are ways to mitigate the impact of the expected increase of credit risk on financial stability. First, it is for banks to proceed with the early and transparent recognition of any deterioration of asset quality. It is imperative that investors do not lose their trust in the EU banking sector as in the aftermath of the GFC, when banks were perceived to be hiding losses in their balance sheets. Banks need to have enough provisions. This crisis may be less harmful than we expect or the recovery faster but, at this stage, it is safer to err on the conservative side.

Low for long interest rates can have a positive mitigating impact on credit risk, but it should not lead to unjustifiable delays of non-viable firms, nor to the delay in recognition of potential non-performing exposures. The same principle should apply to the banking sector itself. The low interest rate environment should also not delay a long-due restructuring of the sector and the orderly exit of weaker banks. In addition, low for longer interest rates will make it harder to regain profitability through credit intermediation.

Banks need to redefine their business models, find other income sources, partly embracing innovation but also leveraging on their traditional competitive advantage in serving their customers, offering advice and higher value added services, and supporting their migration towards a greener economy.

Finally, the crisis has also confirmed the urgency to complete the Banking Union and remove any obstacles to the free flow of capital and liquidity in the Single Market. The construction of the banking union provided financial stability, higher transparency and a more homogeneous framework for banks in Europe. However, the additional potential benefits of cross-border financial flows, private risk sharing, and more competitive pressure that exploits economies of scale in a larger market have not been achieved. In addition, a market for corporate control that forces weaker banks to either enhance their business model or exit has very limited effectiveness given the structure of the sector across the union. The intensity of cross-border flows in banking activities has not increased since the banking union. Cross-border mergers and integration are seen as non-attractive for banking executives. Finally, orderly exit from less competitive banks is very limited and often raises concerns on financial stability.

All these challenges point to the need to have a finalised banking union. The current banking regulatory and supervisory framework puts a high focus on how crises would be managed, assuring financial stability at the national level, but it stills lacks certainty and control over how crisis and resolution related decisions will be taken.

National policies to address national stability concerns can often impede the free flow of funding across the union. Ring-fencing generates barriers to the single market and eventually results in the inefficient allocation of resources, poor incentives to cross-border consolidation, and higher costs for customers. We need a banking sector in Europe with less constraints on the movement of capital and liquidity across countries, lower concerns on whether the bank operating in a member state has local resources to serve the local market in cases of crisis, and more assurance that the single market will continue to operate effectively in moments of difficulties.

The Covid-19 crisis has also made some weaknesses in the EU banking sector more visible and accelerated some trends affecting the industry. In this sense, the crisis can represent a catalyst to restructure and make EU banks more resilient and efficient. Some issues are generalised across the sector, while others may be more idiosyncratic.

Profitability remains too low and enhancing the business model to ensure adequate profitability is necessary. The EBA analyses show that the sector is overall resilient. Our ongoing EBA stress Test will provide further information on the individual situation of banks. Nevertheless, deteriorating asset quality and the 'lower for longer' interest rate environment are expected to weigh on an already subdued profitability.

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. As I said before, a coherent and consistent application of the European resolution framework is a precondition of an orderly exit for those banks that become non-viable in the crisis. Although the challenges ahead are huge, the crisis can be the catalyst to address pre-existing vulnerabilities.

Finally, digitalisation and the use of ICT was able to progress rapidly in the crisis. A further acceleration in the use of these technologies could be a game-changer for banks and it requires large investments. 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 and careful consideration of the environmental and social implications of enhanced use of digital channels and machine led offerings.

Final Remarks

To conclude, while the crisis is ongoing, I would also advocate taking enough time to reflect, discuss and make decisions before changing the rules as it would be premature, imprudent and could be interpreted as a signal of weakness of the banking sector. Once the health crisis is – hopefully – under control and the economy in a clear recovery path, it will be natural to make a stock-take of the elements that have worked well and those deserving some adjustments.

The regulatory framework built after the GFC has proven overall to be fit for purpose. It has helped build the resilience of banks prior to the crisis while showing adequate flexibility to address the short-term challenges. Nevertheless, some lessons can be drawn from the crisis. For the global prudential framework, the degree of flexibility on the usability of capital buffers is an area for further assessment. For Europe, the conclusion of the banking union and a recovery and resolution regime that provides predictability and confidence on how banking crisis will be dealt remains a pressing concern.