# How should the banking framework evolve in the context of the economic crisis?


## Yves Mersch

**Member of the Executive Board and Vice-Chair of the Supervisory Board of the ECB, European Central Bank (ECB)**


## Supervisory action in crisis times and limits of the ECB's prudential mandate

Faced with the unprecedented challenge of the coronavirus (COVID-19) pandemic, ECB Banking Supervision has deployed a range of measures to counteract pro-cyclical developments. By recommending that banks restrict their dividend distributions, we are supporting their capacity to absorb losses during the crisis and to lend to the real economy. More recently, we have extended our recommendation to restrict dividend distributions by another three months, until the end of 2020. This was not an easy decision. Banks that are profitable and healthy should – under normal conditions – not be prevented from remunerating their shareholders. Restricting dividends can increase banks' funding costs, have an impact on their access to capital markets and make them less competitive than their international peers.

Furthermore, our recommendation may disproportionately penalise well-capitalised lenders and those organised as non-joint stock companies. We nevertheless consider such a "one-size-fits-all" approach warranted in the current situation, but it must be exceptional and temporary. There is an ongoing need for prudent capital planning and, when we decided to extend the recommendation, the situation continued to be marked by elevated economic uncertainty, which hindered banks' ability to forecast their medium-term capital needs accurately. Similarly, while our vulnerability assessment resulted in best estimates of capital depletion on a sector-wide basis under different scenarios, its top-down nature did not allow an accurate breakdown of projections on a bank-by-bank basis.

We will review our recommendation in December and, unless we conclude that the uncertainty clouding banks' capital projections remains elevated, we will go back to assessing planned distributions on a bank-by-bank basis. We prefer being prudent today to having regrets tomorrow should overall economic conditions deteriorate further.

Other institutions have joined the effort to keep the financial taps open for the real economy during this exceptional period. After the "quick fix" to the Capital Requirements Regulation, the European Commission has recently adopted a Capital Markets Recovery Package to make it easier for capital markets to support the economic recovery. The proposal to amend the Securitisation Regulation includes a recital whereby the European Central Bank (ECB) is to ensure compliance with requirements on direct risk retention, transparency and the re-securitisation ban. In our view, this is problematic.

> *Extraordinary supervisory action is warranted in times of crisis. The ECB cannot, however, assume tasks beyond its prudential supervision mandate.*

The ECB has recognised its competence to supervise banks' adherence to some securitisation obligations that are prudential in nature, e.g. proper credit granting criteria for exposures to be securitised. However, the additional tasks should be viewed as primarily relating to supervision of product markets, as these rules ensure alignment of interests between investors and originators, and sponsors and original lenders, and allow investors to understand, assess and compare securitisation transactions. The ECB cannot assume tasks which go beyond its prudential supervision mandate as stipulated in Article 127(6) of the Treaty on the Functioning of the European Union and the SSM Regulation. A recital cannot change these limitations by simply re-labelling financial product supervision tasks as prudential tasks.

Assigning these functions to the ECB could result in conflicting responsibilities. In its role as prudential supervisor, the ECB generally wants as little of the risk as possible to remain with a bank acting as originator, so as to minimise arbitrage opportunities with the corresponding reduction of capital requirements. At the same time, the competent authority needs to ensure that the bank retains a material net economic interest under the obligation of risk retention. This might be linked to the need to preserve proper credit granting standards but might also create possible conflicts with the ECB's objective as prudential supervisor.

To conclude, the proposed conferral of tasks is neither a viable allocation of labour nor is it legally tenable.


# Pablo Hernández de Cos

Governor, Banco de España


## Europe should commit to global financial cooperation for its own recovery

History has shown that collective measures to tackle global problems reinforce individual countries' efforts. In fact, the need for timely and proactive global collaboration is even more important in times of stress. Combatting infectious diseases and safeguarding financial stability are both global public goods which know no borders and require collaboration among countries. We must avoid fragmented and disjointed measures. What implications does this have for European financial policies to foster a fast, sound and complete economic recovery across all EU countries?

First, Europe should champion full adherence of its financial policies to global standards and strengthen its contribution to international cooperation so as to mitigate the risks of costly global financial fragmentation. A decade ago, the Basel Committee on Banking Supervision agreed to a comprehensive overhaul of its regulatory standards in response to the global financial crisis. We are now seeing the full benefits of this, and our commitment should hold fast given the current urgency of combating the crisis. The banking system entered this crisis on a more resilient footing than twelve years ago, reminding us of the importance of a strong banking system, underpinned by global and prudent standards whose implementation, if so required, can be swiftly adapted in coordination. This proved particularly helpful in this crisis regarding capital and liquidity buffers. It will thus be critical to ensure the EU implements the outstanding elements of Basel III in a full, timely and consistent manner.

Second, all national and EU authorities should embrace a general equilibrium approach and consider all financial sector/real economy interactions. Under this approach, it becomes apparent how the robustness of the banking sector is key to the resilience of the economy as a whole. In this regard, banks have helped cushion the temporary supply and demand shocks triggered by the pandemic, supported by swift monetary, regulatory, supervisory and fiscal policies; and credit supply should help spur and fuel the recovery phase. But, undoubtedly, the crisis will significantly impact the quality of banks' credit portfolios, on a scale that will depend on its ultimate severity. And we know that an economic crisis, combined with a financial crisis, tends to be deeper and longer. Banks and authorities must thus closely monitor and mitigate risks and vulnerabilities and stand ready to reinforce banks' resilience if needed.

Third, cooperation can also be decisively enhanced within Europe. In the wake of what some have even called a Hamiltonian moment for the EU, with the approval of a common recovery fund, there are still striking gaps in the euro area financial architecture preventing the full eradication of fragmentation risk among European countries. Plugging such gaps by finalising the Banking Union with the creation of a mutualised European Deposit Insurance Scheme, by pushing ahead with the initiatives under the Capital Markets Union and by taking full advantage of the forthcoming issuance of sizeable amounts of European safe assets should also be at the fore of EU financial policy priorities. That may help create the appropriate institutional and regulatory conditions for banks, investors and other stakeholders to adapt to the profound challenges the financial sector is and will be facing in the future.

The pandemic has made some pre-existing challenges more pressing, e.g. low bank profitability, the opportunities and disruptions of financial technology, the impact of the continued rise in both government and private-sector debt, and the increasingly important need to mitigate climate-related financial risks. And new challenges might emerge due to structural changes in the post-pandemic economy. Let us give savers, investors, financial clients and all European citizens the best chances to adapt and succeed in the resulting landscape.

# Robert Holzmann

Governor, Oesterreichische Nationalbank

## How should the EU banking framework evolve in the context of the economic crisis

The EU banking sector was already facing several challenges before the COVID-19 pandemic wreaked havoc on the real economy. Over the last years, European banks have been struggling to adjust their business models to overcome low profitability. They had to cope with new challenges such as the digital revolution and the increasing importance of environmental, social and governance (ESG) factors. Moreover, they have been faced with new risks like cybercrime or money laundering. In addition, some banks have yet to reduce elevated levels of nonperforming loans (NPLs) – a legacy from the last financial crisis. In the near future, the COVID-19-related impact on the real economy will pose additional threats to the banking industry.

Given the challenges ahead, the European banking sector and the EU banking framework will continue to evolve over the next years. Among EU banks, the current economic environment could trigger a certain degree of consolidation in the medium term, as banks scramble to achieve economies of scale, to become more cost efficient and to diversify their sources of income to boost their currently low profitability. With a view to consolidation, banking regulation must ensure that there are no unjustified barriers and that new entities resulting from mergers and acquisitions have sustainable business models, comply with prudential requirements, have sound governance and risk management practices in place and can be resolved in crisis situations.

The coronavirus pandemic also acts as an accelerator for digitalization in the banking sector, with digital distribution channels gaining in importance. Here, supervisors need to ensure that banks manage the associated risks in an adequate manner. In the same vein, supervisors will have to further explore using new technologies themselves, e.g. by applying machine learning to analyze big data. It is also vital that banks and supervisors keep an eye on the emerging landscape of fintechs as well as on Big Tech's activities in the financial sector, as these developments might have a huge impact on the structure of the EU financial system and its stability.

Becoming ever more important, ESG risks will likewise impact on banks' business models in multiple ways. Banks need to incorporate climate risks into their risk management systems; they will have to adjust their investment strategies and change the pricing mechanism for their loan portfolios. To ensure that banks implement such changes in a uniform way, ESG risks are being included in the regulatory banking framework.

On the bright side, banks have entered the current economic downturn in a far stronger position than was the case during the previous financial crisis. In the wake of that crisis, a new regulatory framework (Basel III) had been introduced that has required banks to build up capital and liquidity buffers far beyond previous levels. Thanks to this new regulation, banks are now better able to support the real economy in the current crisis by granting new loans. Besides, financial institutions are more resilient, with their capacity to absorb losses having increased substantially. Nevertheless, it is of the uttermost importance that the – currently postponed – final part of the Basel III framework agreed on in December 2017 will be implemented in the EU in a timely manner. This is meant to further strengthen the regulatory framework, e.g. by reducing excessive variability of risk-weighted assets and by improving the comparability of capital ratios, and to contribute to the resilience of the EU banking sector.

In response to the COVID-19 pandemic, regulators and supervisors used the flexibility already embedded in current banking regulation, acting swiftly to provide further temporary capital, liquidity and operational relief to institutions. Specifically, banks were encouraged to use macroprudential capital buffers built up over the last years to support the financing of the economy. These measures should, however, not be interpreted as a sign of a general policy shift toward softer regulation. Importantly, what should be avoided is a permanent reduction of capital and liquidity levels. Capital regulation should remain flexible, i.e. capital buffers may be depleted in a crisis like the current COVID-19 pandemic but will have to be restored to pre-crisis levels once the crisis has subsided. Naturally, banks should also heed the lessons from the last financial crisis, which showed the need for both enhanced transparency concerning asset quality and a comprehensive accounting and regulatory reporting framework to ensure market discipline. To grasp the overall picture and analyze the latest developments in a timely manner, supervisors and market participants alike need sufficiently detailed regulatory reporting and transparent accounting systems.

Criticism of banking regulation has been rising; not only has the regulatory framework become stricter and more comprehensive over the last decade, but also much too extensive, and, in some areas, overly complex. From my perspective, this criticism is broadly justified. Both the financial industry and supervisory authorities would benefit from a more transparent and, hence, easier-to-apply regulatory framework. In a next step, we should therefore aim at simplifying the regulatory framework, yet without diluting the underlying prudential intention, to ensure that the banking system is resilient in the face of crises – this will make everyone's life much easier.


# Luigi Signorini

**Deputy Governor and Member of the Governing Board, Banca d'Italia**


## Banks are key to hastening the recovery from the COVID-19 shock

Banks were much stronger at the start of the COVID crisis than they had been when the global financial crisis struck. This was due to a large extent to the reforms that culminated in the Basel III accord. During the 2008 crisis, banks were part of the problem; this time they have been counted on as being part of the solution. Decisive monetary and regulatory interventions were also essential. No sudden liquidity stops have occurred so far; no credit crunch has threatened to compound the effects of the real shock. Stronger banks have therefore supported a crisis-hit economy.

However, the crisis is not over. The authorities must remain vigilant and ready to act, to avoid financial disturbances. The challenge for banks is to provide credit to the economy while maintaining the soundness of their balance sheets. Immediately after the shock, European banks accommodated the surge in firms' demand for liquidity, helped by public relief measures (especially in the form of guarantees) and a very accommodative monetary policy.

The deteriorating macroeconomic scenario led to a sharp increase in loan-loss provisions in the first half of the year; further losses will probably be recorded in the next few quarters, as the phasing-out of support measures, coupled with higher private sector leverage, continue to affect asset quality. The economic contraction is likely to erode operating income, thereby slowing down the demand for loans and other banking services. Lastly, notwithstanding the ECB monetary policy measures and the decision to set up an EU Recovery Fund, in some Member States banks remain vulnerable to a reassessment of sovereign risks, which may increase their funding costs.

However, while profitability will remain under pressure for some time, the resilience of the euro-area banking system has not been called into question. The recent ECB vulnerability analysis has shown that the reforms and supervisory actions have effectively increased their strength. The challenges are serious but can and must be managed.

As banks hold much of the EU corporate debt, their financial and advisory support will be crucial in keeping viable businesses operating. Restoring a sound corporate financial structure would strongly benefit from the completion of the Capital Markets Union, which would allow firms to diversify their financing sources and raise equity on better terms.

Banks should rapidly process NPLs resulting from exposures to non-viable firms, and their recent positive experience on NPL disposals and management will be valuable. Public authorities should be ready to explore solutions for safeguarding the system's stability; they should consider preventive tools – such as publicly sponsored asset management companies – to help banks maintain a healthy balance sheet. Adjustments to the European bank crisis framework should also be considered, to guarantee the orderly management of any troubled institutions, regardless of size.

The pandemic shock has accelerated the digitalisation of the production and distribution of goods and services. The transition to a digital economy requires corporates to undertake substantial investments, and bank financing will be crucial, especially for SMEs. Digitalisation is both a challenge and an opportunity for banks, and they too will need to invest heavily in innovation to survive and prosper. Indeed, while coping with the short-term and acute effects of the crisis, they must still take the long view.

Ultimately, the long-run health of both the economy and the banking system depends on effective fiscal and structural policy actions to ease the pain of the crisis for firms and households and foster balanced growth. In the meantime, supervisors and regulators should continue to exploit the flexibility of the regulatory framework, striking the right balance between allowing banks to absorb the impact of the downturn as smoothly as possible, and maintaining safe and sound risk management practices.


# Othmar Karas

Vice-President, European Parliament


## The impact of the COVID-19 crisis on EU financial market legislation

We are living through unprecedented times. The COVID-19 crisis is affecting the health of our loved ones and profoundly impacting our economy and financial markets. A global challenge of this kind needs to be tackled with determined and coordinated action at all levels. It is essential to have a common European response, which preserves the integrity of our Single Market, avoids national fragmentation, and ensures that the financial sector can be part of the solution. Unlike in the 2008 financial crisis, financial institutions are not the source of the problem this time. The banks' higher liquidity, capitalisation and leverage undoubtedly serve us well during the current shock. The fact that we are much stronger now than when the financial crisis hit us over ten years ago shows that continuing to strengthen our Economic and Monetary Union is the right way forward. And if we all live up to our responsibilities, we will emerge stronger also from this crisis. Just as in the spirit of Robert Schuman who knew as long ago as 1950: *"Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity."*

Of course, the pandemic is also impacting the EU agenda on financial market legislation. The Commission's proposal on the comprehensive Basel-III reforms has been postponed given the announced one-year deferral by the Basel Committee's oversight body. A decision which I very much welcome since it increases the operational capacity of banks to support our real economy at these exceptional times. At record speed, the European Parliament and the Council have adopted a Banking Package offering capital relief to boost extra lending potentially worth up to 450 billion euros to households and businesses throughout the EU. At the same time, public authorities, supervisors and bodies at Union, Member-State and international level have taken swift and decisive action, complemented by an Interpretative Communication by the Commission. And still in July, the Commission proposed a Capital Markets Recovery Package with the objective to make it easier for capital markets to support the European economy to recover from the crisis.

In particular the swift adoption of the revised banking rules shows how quickly the EU legislator is able to act at times of crisis. Amid the application of the ordinary legislative procedure, the setting of tight procedural deadlines and the continuous dialogue between the co-legislators and the Commission allowed the adjustments to enter into force still in the second quarter of 2020. This sets a positive example for the upcoming procedure on the Capital Markets Recovery Package, which should encourage greater investments in the economy, allow for the rapid re-capitalisation of firms and increase banks' capacity to finance the recovery. The changes to MiFID II, the securitisation, prospectus and benchmarks rules should ideally be adopted before the end of the year. Waiting for the comprehensive reviews on these rules – scheduled for MiFID II/MiFIR in 2021 and for securitisation in 2022 – would mean missing the opportunity to use the full potential to help the Union to recover from the crisis. In the same vein, the amendments must remain targeted and focus on the COVID-19 recovery.

> *The necessary completion of our Banking and Capital Market Union is gaining ever more importance due to the current crisis.*

In fact, the necessary completion of our Banking and Capital Market Union is gaining ever more importance due to the coronavirus crisis. On the Banking Union side, whereas the benefits of the first two pillars – the single supervision and resolution – are delivering, the gradual implementation of the third pillar on a European Deposit Insurance Scheme as well as the regulatory treatment of sovereign risks must gain momentum. While the EU legislative train on the Basel-III reforms is delayed, it must continue being loaded with the practical expertise from all affected stakeholders. At the same time, a successful Banking Union also needs well-functioning capital markets. On the CMU side, the common objective must be to ensure equal access to investments and funding opportunities across the Union. One important aspect is the harmonisation of core elements of national insolvency regimes to improve comparability and predictability for investors. Following the publication of the final reports by the Next CMU High Level Group and the CMU High Level Forum, the European Parliament is currently adopting its position ahead of the Commission's CMU action plan to be proposed in September. Undoubtedly, the experience of all public authorities and financial institutions with the consequences of COVID-19 must be at the heart of both projects.


# Alban Aucoin

**Head of Public Affairs, Credit Agricole Group**


## Time to design a new normal

*"When men find themselves in a new situation, they adapt and change. But as long as they hope things can stay as they are or be compromised, they are not willing to listen to new ideas"* Jean Monnet, Memoirs.

The outbreak of the Covid is a game changer. The unprecedented magnitude of this exogenous shock will have long-lasting consequences such as aggravating the prior over-indebtedness of households, companies and States.

In this context, the European Union agreed on a major recovery plan, with great ambitions in terms of sustainable development, climate change, digital revolution and finally assumed defence of its industrial sovereignty. The EU has been able to change and adapt to this new context, by approving an exceptional budget reinforced by the new instrument Next Generation EU, directly financed by the issuing of EU bonds - a fine symbol of a new European solidarity.

However, the European Union and the Member States will not be able to support the economic recovery by their own, as their room for manoeuver has been reduced by high levels of public indebtedness. From this background, the financial sector will have a key role to play alongside and in partnership with public authorities as it has already shown, by massively providing liquidity support to companies. Given the predominance of bank-based financing, due to the lack of a strong European capital Market, the bulk of this financing effort is borne by banks. Thus, they have seen their balance sheets growing dramatically.

Therefore, the European banking framework must also adapt and change. The crisis has highlighted the procyclicality of many regulations, which instead of stabilizing the economy have significantly amplified the movements. To mitigate some of these effects, supervisors and regulators have quickly adopted a broad range of relief actions. In the same vein, banks have welcomed the targeted legislative changes of the prudential framework known as the CRR Quick fix. Nevertheless, an in-depth review of the prudential framework, in which some measures are structurally very pro-cyclical, must be undertaken.

Future regulations such as Basel 4 are also pro-cyclical over time. Indeed, an increase of capital requirements reduces the financing capacity of banks, as the SSM admits in its press release of 20 March 2020. The last EBA estimates of a 24% increase of capital requirements resulting from the transposition of Basel 4 into EU law, would freeze a lot of capital necessary for the massive financing of the recovery and greening of the European economy. European banks' financing capacities would be further weakened by the impact of the pandemic crisis: the SSM estimates the impact of the crisis on the banks' CET1 ratio between 1.9 and 5.7 pp, depending on the scenarios, with a peak in 2022.

*Future regulations such as Basel 4 are also pro-cyclical over time.*

In this context, the current situation leads us to question the transposition of a framework designed to address the issues of a crisis which occurred more than ten years ago, and based on an agreement which does not respect the mandate of no significant increase in capital requirements given by the European institutions. While banks are living a large-scale stress test, bringing uncertainty to the financial and banking sector, the SSM has recognized in its July 28th vulnerability analysis the adequate capitalisation and liquidity of banks.

It is therefore essential to put into perspective the need to finance the ambitions of the European Union and the objective of financial stability, which is already at an appropriate level. Prior to the publication of the legislative proposal to transpose the 2017 Basel Agreement and its impact assessment, a meaningful and thorough political debate and a close dialogue between regulators and industry should be seriously considered. This is necessary to make a sound decision on such a consequent regulatory reform that would not match with the European interests anymore. ●


# Kinner Lakhani

**Head of Group Strategy & Development and Head of Investor Relations, Credit Suisse**


## Europe needs a healthy banking system to build back after Covid-19

The European banking system has proved to be resilient in the wake of the COVID crisis but the outlook has become ever more challenging in the context of lower-for-even-longer interest rates; a likely uneven recovery; the burden of higher levels of non-performing loans; and the need to rebuild balance sheets. However, unlike 2008, the need for refinancing and recapitalization are greatest for the corporate sector. Banks – both traditional and central – together with sovereigns have and will continue to play a central role. The recovery of the European economy is inextricably linked to the health of its banking system, the largest in the world. After all, Eurozone banks provide three-quarters of corporate and nine-tenths of household financing – double and triple the proportion in the US[1].

In the context of an ever more challenging outlook, the need for structural reform of the financing of the European economy is greater than ever. The Achilles heel of Europe is the overdependence on its banking system. The fragmented structure of European banking – the top five banks have less than one-quarter of banking assets while the US market is twice as consolidated[1]– structurally weighs on returns. This fragmentation is equally evident in cross-border banking – representing a mere 1% of mortgages and less than 10% of corporate loans[1]– as well as in capital markets. Regulatory reform of the banking sector, while it has been critical to its resilience through the health crisis, could remain in train for almost two decades after the Global Financial Crisis.

We support the renewed political momentum, under the Germany EU Presidency, to complete Banking Union. This is critical to breaking down the barriers to cross-border consolidation – including national ring fencing of capital and liquidity – and allow for a more integrated banking system. While consolidation is necessary, we believe it is insufficient. Policymakers also need to bring down the barriers to consolidation in the non-listed part of the banking system, often with implicit state support.

The other side of the coin is Capital Markets Union where we welcome the reinvigorated focus, especially in the context of Brexit. The need for deeper, more liquid, more integrated capital markets is greater than ever not just to support the recapitalization of the corporate sector but also financing the investments needed for digitalization and the sustainable economy.

The recent health crisis has shown both the effectiveness of post-crisis banking reform but also exposed its pro-cyclicality, as well as the need to address liquidity risks in capital markets. Whilst regulatory forbearance to counter pro-cyclicality has been effective, it has been unevenly applied - a reminder that banking is global during normal times but national during crises. The final phase of Basel 3 reforms should incorporate lessons learned from the crisis and that temporary forbearance measures, including IFRS 9 relief, will reverse over time serving as headwinds to banks' capital ratios. The overall capital buffer should embed a larger counter-cyclical component to serve as a more effective 'shock absorber'. The negative impact of the inevitable expansion of central bank reserves on the leverage ratio from central bank programs is clearly counterproductive.

> *The recovery of the European economy is inextricably linked to the health of its banking system.*

Banking and capital markets continue to play an important role in supporting the nascent economic recovery. However, policymakers need to be ambitious in "Building back better" to support corporates and households recover from the tragic effects of the COVID crisis. For European banking, this means completing the long overdue Banking Union, Capital Markets Union and a considered approach to completing Basel 3 reforms, now well into the second decade after the Global Financial Crisis.

1. How to fix European banks and why it matters, Lakhani, Folkerts-Landau, Reid et al


# Johanna Lybeck Lilja

Executive Adviser, Nordea Bank


## Banks' support to the economy; in normal and distressed times

We are currently living in difficult times. The pandemic Covid-19 has severely impacted people, countries and economies around the world. Governments, central banks and other authorities have implemented measures at an unprecedented scale to support their economies. Compared to the financial crisis of 2008, the financial system and in particular the banks are not the problem, but part of the solution.

This is true especially in countries where banks have strong capital and liquidity positions in combination with robust earnings. The Nordic region is one example where the banks have been able to support their customers and subsequently the economy through these difficult times. Taking Nordea as an example, active credit management over the last ten years has significantly de-risked the credit portfolio, resulting in the loan book being well-diversified with a strong underlying credit quality. This has enabled the bank to continue to support customers during the Covid-19 outbreak; e.g. lending to households and corporates has increased in both of the first two quarters of 2020 and many customers have asked for, and been granted, an amortisation-free period. A significant management judgement buffer has recently been put in place to cover future losses.

In addition, Nordic banks have made use of the government guarantee programs for the extension of credit to corporates. This has enabled further much-needed lending to support the economy. Going forward, it is crucial that the support measures are sustained to support the starting-up of the economies.

Looking ahead, one of the most important legislative files is the implementation of the final part of the Basel III capital requirements in the European Union. Work is ongoing in the EU Commission and several impact studies have been performed. These show a significant proliferation of the expected impact on banks of the revised capital requirements.

This is true at the global level, but significant differences are also found within the EU, e.g. the expected rise in the minimum capital requirements is estimated to around 30 percent in some of the Nordic countries. Taking into account the important role that banks have in the real economy and the society, including the potential societal impact of problems in the financial sector, we clearly support strong requirements on all financial institutions, also capital requirements. At the same time, it is important that regulatory capital requirements adequately reflect the risks that the bank takes. In the end, capital bears losses and losses are driven by risk.

So why are the Nordic banks characterised by low-risk assets? Firstly, the Nordic banks learned the lesson of prudent credit extension focussing on the ability to repay the loan the hard way in the respective financial crises the Nordic countries experienced in the early 1990's. Secondly, a large share of the loans by the banks are household mortgages collateralised with property. Thirdly, Nordic societies have well-structured social safety nets, strong fiscal positions and effective legal systems. This means that citizens are protected from severe economic situations and can most often continue to repay the loan and that, should it become necessary, the process of claiming the collateral is comparatively efficient.

> *Regulation of the financial market needs to be strong, balanced and risk-sensitive.*

Consequently, the EU implementation of the final part of Basel III should avoid penalising low risk portfolios and ensure that the regulatory framework matches the actual risks. If part of the intention of Basel III was to further disincentivise the holding of high-risk assets then this will do the opposite, creating a penalising effect for holding assets like low risk household mortgages and loans to high (credit) quality Nordic corporates. This would clearly distort the incentives for banks when it comes to business selection and pricing and can create a negative impact for the financing of Nordic corporates and households, ultimately making the Nordic financial system less robust.

Had the final part of Basel III been implemented in the EU at the time of the outbreak of Covid-19, Nordic banks would not have been able to support the household and corporate customers to the extent that we have thus far. To sum up, the regulation of the financial market needs to be strong, balanced and risk-sensitive.