Should we be concerned about post-Covid financial stability?

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A sound framework to safeguard financial stability

The COVID-19 pandemic constitutes an unprecedented global shock. The latest economic forecasts point at the deepest recession since World War II and, at this stage, we do not yet know its full and final impact on the economy: it remains a very large 'known-unknown'.

In mid-March, stress metrics reached historical high levels, and strong market reactions led to major re-pricing in the financial markets, including sharp declines in bank equity prices. The large uncertainty surrounding the scale and duration of the pandemic's economic impact provoked acute stress in key funding markets (including US dollar liquidity markets), unleashing concerning destabilising dynamics and jeopardising financial stability.

Fortunately, during the last few months we have seen some easing of financial conditions and a substantial (although asymmetric) asset price recovery. This is the result of two main factors. First, we have much firmer foundations in place across Europe today than a decade ago. It is often said that one should never let a crisis go to waste. In Europe, we acted on the lessons of the financial crisis, and are now harvesting the benefits of that work.

The banking system is today more resilient as a result of the regulatory reforms adopted in the aftermath of the previous crisis. Banks have higher capital and liquidity buffers and lower NPL ratios, proving that the system on average is fit for purpose and can absorb shocks. Without the existing institutional and regulatory framework, a recession of this magnitude would have had immediate devastating effects on our banks and therefore on financial stability.

The ECB's most recent vulnerability assessment by contrast showed that, overall, banks in principle can withstand pandemic-induced stress, although there is still large uncertainty regarding the final magnitude of the crisis.

Second, swift and bold policy actions adopted by the authorities have substantially contributed to cushioning the global hit and thus safeguarding financial stability, including unprecedented ambitious monetary and fiscal measures.

At the SRB, in line with other European authorities, we have focused on giving banks operational relief but simultaneously moving forward with our resolution planning. Coordinated policy action by public authorities is supporting the banks' capacity to absorb losses and to channel funds to the real economy, which is especially relevant in times of large revenue shortfalls.

We have adopted a transparent and pragmatic approach, using the existing flexibility in our legal framework while ensuring that we do not undermine its credibility. Disorderly bank failures have proven their devastating effects in the past. Avoiding them is precisely our *raison d'être*. We cannot roll back recent reforms that have made our banking system more robust. Focus on making banks resolvable is key to protecting financial stability.

To conclude, the financial and economic outlook is still largely uncertain. The second quarter data point to an unprecedented and severe recession and an uneven recovery, as the economic toll of the lockdown is proving more severe than initially expected. Second-round effects like increased unemployment or precautionary savings could put further strain on the economy. High levels of debt may prove challenging for some borrowers, especially in case of a second wave of infections or hysteresis. Until now, banks have proven their resilience. Recent regulatory reforms have put our banks in a better shape to cope with the crisis, but they are not bulletproof. Banks are under severe profitability pressure, and asset quality deterioration would imply an additional burden at least for those institutions that are still recovering from the financial crisis. If the situation worsens, depletion of bank capital would be material.

> *The banking system is today more resilient as a result of the regulatory reforms adopted in the aftermath of the previous crisis.*

Looking forward, we must continue our work on the completion of the Banking Union, building on the progress achieved thus far. We will continue to support the recovery and strive to ensure that banks keep on acting as a countercyclical force, and not as an amplifier of financial instability.

If, and when needed, we have the appropriate tools to manage bank failures effectively and avoid financial instability. We also firmly believe they will be up to the task. Solid resolution planning and resolvable banks are the best safeguard of financial stability.

Denis Beau

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After the Covid shock, treading carefully and drawing the necessary lessons

Several months into the pandemic, we are still grappling with its consequences: speaking of a "post-Covid" world is premature. The public health dimension is and will remain front and center in the near term. As for the economic outlook, the worst may be over but the speed and extent of the recovery remain uncertain and the economic and social consequences of the pandemic will remain with us for quite some time (when they have already surfaced yet).

So far, potential threats to global and European financial stability remain under control. Two factors proved decisive so far for navigating this stormy sea. First, the banking sector held up, providing a clear vindication of the reforms introduced in response to the global financial crisis, and allowing it to contribute to the support of the real economy. Second, swift, simultaneous and massive measures taken by economic and financial policy makers have helped dampen the shock to the real economy and maintain the stability of the financial system as a whole.

Yet, we are not out of rough waters. The current circumstances call for remaining cautious in the near term, executing a balanced exit strategy over the medium term and addressing longer term challenges.

In the near term, the strong improvement in sentiment and associated markets rally call for caution. While a positive development in itself, it raises the probability of a disconnection between asset prices and underlying economic conditions. Managing market sentiment is elusive, especially in such uncertain times. But reining in excessive risk-taking and being prepared for the possibility of a market correction will be key to ensure financial stability.

Current geopolitical risks only compound these concerns. Now that uncertainty around the Brexit timeline has been lifted, all stakeholders must finalize their preparation to smoothly get past the end of the transition period or collectively face a renewed risk of market stress in an environment already weakened by the Covid.

Massive public support has provided essential protection to households and firms. A decisive and most welcome step forward has also been taken at the EU level with the European Commission's Next Generation EU proposal, which should strengthen the EU's economic stability by introducing a mechanism for fiscal solidarity between State members critically lacking until now. Both –public support and fiscal solidarity- were and are still necessary but should not give way to complacency vis à vis the need to tame –in due time- fiscal spending to ensure fiscal sustainability.

Public support needs indeed to be carefully managed and eventually phased out in order to avoid backfiring to the real economy through worsening financial conditions. At a later stage (but sooner rather than later), refilling the buffers that helped cushion the shock in the banking sector will be necessary to ensure that the banking system remains part of the solution to ensure the recovery of our economies.

Finally, "pre-Covid" longer term developments and associated risks need more than ever to be addressed.

At the top of the list lies high levels of debt, and leverage, which exacerbate risks. Despite public support, an upturn in corporate insolvency risk and bankruptcies could weaken banks' balance sheets and weigh on the credit supply the recovery depends upon. Accordingly, negative shocks to households' income would increase the weight of debt service, resulting in slacker consumption and, in more extreme scenarios, greater credit risk. The "post-Covid" recovery will have to avoid overreliance on debt fueled growth and the associated build up in vulnerabilities.

> *"Pre-Covid" longer term developments and associated risks need more than ever to be addressed.*

In addition, the stress in a number of core markets in March laid bare the vulnerabilities of market based financial intermediation. It only receded thanks to massive central banks' interventions and highlighted tensions between individually legitimate actions (e.g. MMF seeking to strengthen their own liquidity position) and their destabilizing consequences (exacerbated liquidity stress for other stakeholders, including banks and corporates). A much more comprehensive macroprudential framework is long overdue to effectively underpin financial stability.

Finally, the massive scaling up of remote working brought about by the pandemic heralds an acceleration in the digital transformation of the overall economy. For the financial sector, it entails major challenges to business models' , exacerbates cyber-risks and requires major investments going forward. Similarly, the pandemic shock is a foretaste of what is just around the corner if climate change is left unchecked.

Not only banks and other financial institutions should proactively adjust to the low carbon transition and brace for adverse physical risks likely to materialize even in a 2°C world but, just as they did in this crisis, they should aim for being a decisive part of the solution. ●

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COVID-19 pandemic: financial stability implications for the EU financial sector

Following the onset of the COVID-19 pandemic, EU bodies, national governments, central banks, and supervisory and resolution authorities took unprecedented action to support the economy. Responding to the initial shock in financial markets, the ESRB General Board identified and took measures in five priority areas: (i) the implications for the financial system of guarantee schemes and other fiscal measures to protect the real economy; (ii) market illiquidity and its implications for asset managers and insurers; (iii) the impact of procyclical downgrades of bonds on markets and entities across the financial system; (iv) system-wide restraints on dividend payments, share buybacks and other payouts; and (v) liquidity risks arising from margin calls. Beyond the immediate financial market volatility in March and April 2020, significant challenges remain. In June 2020 the ESRB reviewed its systemic risk assessment to account for recent developments. A key systemic risk stems from the widespread defaults in the real economy which are expected in light of a deep global recession. This is likely to result in a challenging macroeconomic environment for both banks and non-banks.

The European Central Bank (ECB) completed its vulnerability analysis of banks to assess the sector's resilience to stress caused by the Covid-19 pandemic. As the planned EU-wide stress test exercise was cancelled due to the pandemic, the ECB's top down analysis provides a best estimate of the sector's resilience. The assessment includes a severe stress scenario where real GDP falls by 12.6% in 2020 which would deplete banks' average CET1 from 14.5% to 8.8%. Key drivers for the modelled fall in capital are impaired credit exposures, market risk losses and lower profitability. Several banks would need to take action to maintain compliance with their minimum capital requirements, but the overall shortfall would remain contained. The high level of resilience in banks is a reflection of the regulatory reforms since the 2008 global financial crisis as banks are facing the current crisis with significantly higher capital levels. With bank profitability strained in recent years, those banks that have previously strengthened their profitability through efficiency-enhancing measures tend to be better positioned to withstand a severe stress. When entering the next phase of the crisis, it will remain important for banks to deploy their capital effectively. With its recommendation, the ESRB is supportive of financial institutions (banks, insurance corporations and CCPs) choosing to preserve their capital resources through dividend restrictions in these critical times, until end January 2021. This can help to enhance the resilience of the financial sector, strengthen its capacity to lend to the real economy as the crisis unfolds and reduce the risk of failure of financial institutions.

Risks also remain elevated for the non-bank sector where a deterioration of liquidity in financial markets can pose significant challenges. The ESRB took several measures at the onset of the crisis to help address risks faced by investment funds and insurers stemming from market illiquidity. This included a statement highlighting the importance of the timely use of liquidity management tools by investment funds, a Recommendation to ESMA to undertake a focused supervisory exercise to assess vulnerabilities in some segments of the investment fund sector, and a communication to EIOPA supporting increased monitoring of liquidity risk in insurers. Given the expected rise of defaults in the real economy, the mechanistic reliance on credit ratings by some institutions could pose a risk to financial stability. The ESRB therefore conducted a system-wide scenario analysis to help assess future possible fire sales which could be triggered by widespread simultaneous bond downgrades.

While the current focus particularly remains on responding to the immediate crisis, the ESRB also highlights three additional systemic risks which require continued monitoring. These include operational risks such as a system-wide cyber incident, finance-driven disruptions in critical financial infrastructure, and risks linked to climate change. Given the large potential impact of some of these risks, continued progress to tackle them will remain important while navigating the current crisis. ●

Jose Manuel Campa

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The Corona crisis: a chance to build a stronger and more viable banking sector

The outbreak of the Coronavirus has brought huge social disruptions and unprecedented economic challenges. Banks have entered the crisis on a sound footing thanks to the post Great Financial Crisis' (GFC) reforms. Capital ratios are relatively high, with a CET1 ratio of 14.4% in Q1 2020, which compares with 9% in 2009. Management buffers of capital above supervisory requirements, and the release of macroprudential- and other supervisory buffers have provided room for banks. However, expectations for banks to manage this crisis well are high. Banks are also maintaining stable liquidity positions, with LCR at 148.9% in Q1 2020 (149.9% in Q4 2019). Banks' funding compositions are moreover healthier nowadays than at the outbreak of the GFC, not least thanks to higher shares of deposits from households and non-financial corporations in the overall funding mix. Banks are also making strong use of favourable conditions on wholesale funding markets, and quickly resumed issuance activity of debt instruments across the capital structure after funding markets were temporarily closed following the outbreak of the crisis.

While solvency and liquidity ratios are providing certain comfort, concerns are significant when it comes to the outlook for profitability and asset quality. Average ▶

return on equity (RoE) contracted to just 1.3% in Q1 2020, mostly driven by declining net interest and trading income as well as rising cost of risk. Persisting underlying weaknesses, such as low interest- and lending margins, are expected to exacerbate in the even longer for lower interest rate environment. The expected asset quality deterioration in the evolving economic downturn will likely result in markedly rising impairments. Cost of risk already sharply increased to 81bps in Q1 2020, after it had mostly been around 50bps in the past two years. Intense competition and overcapacities in many banking markets, coupled with sticky operating costs, pose further profitability challenges. Online banking and technological solutions are thriving in the crisis, and many banks will face additional needs to embark on ambitious but costly digitalisation strategies.

It is paramount that banks keep on supporting the economy. The EBA encouraged supervisors and banks to make use of the flexibility embedded in the regulatory framework. Several competent authorities released buffers accordingly and allowed flexibility for banks to operate below their Pillar 2 Guidance (P2G). The EBA has emphasised that capital relief should be used to finance the corporate and household sectors and urged banks to refrain from dividend distribution and share buybacks.

Banks legitimately request more clarity about the timing of reintroduction of buffers, as well as a potential lifting of the dividend restrictions. More certainty on these aspects is key but needs to go hand in hand with more certainty on the path of the crisis and its economic impact.

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. 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.

Pre-existing elements of weakness in the banking sector must not exacerbate the crisis. The need to address overcapacities and advance with banking sector consolidation will become ever more important and supervisors are supporting measures to facilitate such process. Addressing overcapacities includes mergers and enabling non-viable banks to exit the markets in a sound and orderly fashion. 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 might as such offer the chance for the banking sector to leave it behind stronger and more advanced.

Nausicaa Delfas

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How can regulators and the financial sector address vulnerabilities raised by the pandemic?

The global health crisis caused by the Covid-19 pandemic and the unprecedented economic disruption that has followed continue to be sources of concern for all. The effects will be felt across the world for some time yet and the broader impact will likely only be fully understood with hindsight.

The global financial system has so far proved to be more resilient than during the last financial crisis, at least in part due to the swift and decisive action taken by financial regulators.

As we look to the challenges ahead and consider the medium to longer-term crisis response, we will need to develop a complete picture of how all elements of the system - including banks, market infrastructure, and the non-bank sector - are interconnected, what the impact of market stress has been and what risks have materialised to date. This should act as the foundation for any future regulatory action.

In the immediate phase of the crisis, at the UK FCA we implemented support measures to keep markets functioning, ease operational pressures on firms where appropriate, and ensure that adequate protection for consumers was provided. For example:

- We modified our rules to facilitate equity and debt capital raising, so firms could provide the necessary finance to businesses as quickly and efficiently as possible;
- We provided flexibility over regulatory requirements where appropriate, such as giving firms additional time to publish annual financial reports;
- We introduced a range of temporary measures to support consumer credit and mortgage arrangements in areas where consumers are in financial difficulty.

In doing so, we have worked intensively with our counterparts in the UK, the EU and globally to address common challenges, share insights on respective market developments, and coordinate responses where appropriate. A number of these actions have been coordinated with the Financial Stability Board, IOSCO, and ESMA; the latter within the parameters of the EU-UK Withdrawal Agreement. Pragmatic and swift

▶ cooperation with our international counterparts was vital when responding to the immediate pressures of the crisis. It is now critical that we continue to work collaboratively on common challenges, towards common objectives.

Recognising the significant uncertainty that remains over the health situation and its economic consequences, focus areas will be:

- Recapitalisation - Market participants will face rising funding challenges as the economic implications of the crisis continue to unfold. To address these, we have started working on proposals to ensure capital markets continue to be a vibrant source of funding for businesses;
- Operational resilience – Sustaining the agility with which firms have adjusted to the unfolding crisis will be important. Alongside the Bank of England, we continue to focus on operational risks, strengthening resilience and business continuity, and minimising consumer harm;
- Systemic vulnerabilities – The FCA is actively contributing to new workstreams in global standard setting bodies to come to a detailed understanding of market stress seen in Spring 2020, and to assess potential vulnerabilities in Non-Bank Financial Institutions (NBFI). Early evidence points to significant diversity in the experience of the non-bank sector, meaning it is too early to draw conclusions without first considering how different elements of the broader system have interacted. We must ensure this work and any future regulatory change considers the benefits of vibrant capital markets alongside the potential risks, not least in the context of a sound economic recovery. Domestically, we are currently consulting on proposals to increase the resilience of property funds during periods of market stress;
- Consumer protection – It will be essential to build on the measures we have taken to date, to ensure the support we offer consumers is sustainable and reflects the needs of the most vulnerable in our society.

Overall, the financial system has proved to be broadly resilient to this crisis to date, without some of the severe market dislocations observed during the previous financial crisis. As then, this crisis has again demonstrated the value of close and pragmatic cross-border coordination between regulators. Nonetheless, it is clear that the crisis is far from over. Both regulators and the industry will need to continue to work hard to ensure the stability of and confidence in our markets, that consumers are given adequate protections, and that the financial sector can play its part in supporting the economic recovery. ●

Dan Sørensen

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Basel III finalisation might reduce European financial stability

The regulatory tightening of the financial sector following the financial crisis of 2008-9, with Basel III 'pre-finalisation' standards at the forefront, has made banks far more resilient and ready to face future crises. However, in recent years, the profitability of banks has been a major challenge. The length and depth of the recession in the wake of the COVID-19 pandemic crisis is yet to be seen, but it is already evident that this crisis affects all aspects of micro- and macroprudential regulation. Nevertheless, so far the updated framework has passed the test and proven that banks are now part of the solution and not part of the problems of a global recession. In combination with the swift response from global and European regulators clarifying or fixing regulatory inconsistencies, this has made banks capable of supporting the real economy through the recession.

Looking forward, the final part of new global standards in the form of Basel III finalisation is yet to be implemented in Europe. It is positive that the European Commission has decided to review its impact assessment in light of the COVID-19 crisis. However, given the current 'live stress test' scenario with increasing credit risk in both a broad and a sector-specific perspective, assessing the extent to which the already implemented Basel III 'pre-finalisation' framework would prove sufficient to deal with severe crisis situations should be strongly considered.

In the current situation for all European banks, any increase in capital requirements will reduce their capacity to support the real economy throughout the COVID-19 recession – and, not forgetting, to accommodate the already pre-COVID-19 urgent need for households and businesses to make sustainable investments. It is difficult to see how banks could improve their profitability although operating cost reductions are on the agenda in many banks. Thus in case of increasing capital requirements, banks will find themselves caught between a rock and a hard place – either cutting the lending book to improve capital ratios or using all retained earnings only to build up capital – in both cases not capable of maintaining their lending capacity to the creditworthy part of the real economy.

> *Any increase in capital requirements will reduce the capacity to support the real economy.*

From a broader perspective, the Basel III finalisation standards have not been calibrated taking European specificities into account. For instance, European specialised, low-risk banking business models might end up being less resilient in a crisis. European banks have a much larger share of low-risk lending on their balance sheets compared to e.g. US banks, something that will be severely punished by the new 72.5% output floor, which will greatly increase REA levels and thus capital requirements in spite of no clear risk reduction effects. One example is Danish mortgage lending, characterised by especially low risk and therefore even more susceptible to this. Danish credit institutions will need another EUR 10bn of capital – corresponding to a 34% increase in capital requirements. Thus, with the prospect ▶

of such a massive increase in capital requirements, for many banks it would be best to drop their low-risk business activities and instead include far riskier exposures in their lending book. This will be a problem for financial stability when the next crises hit the real economy.

The reforms implemented immediately after the financial crisis were well founded and addressed a fundamental lack of risk management in certain parts of the financial system. With Basel III finalisation, this fundamental motivation for risk management will be undermined, and the ability of banks to make quick and flexible adjustments and support the real economy in a crisis will be reduced. Based on the current shock to the global economy, it is time to reconsider the implementation of the Basel III finalisation framework.

Stefan Simon

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Banking on recovery: balancing stability and growth in the wake of the pandemic

The COVID-19 crisis has demonstrated the resilience of the European financial system in the face of extraordinary challenges. With aggregate total capital ratio in Q1 2020 standing at 18.1%, and liquidity well above 100% of the LCR, Euro area banks have shown their capacity to absorb losses, maintain market liquidity and extend credit where needed.

In general, the regulatory and supervisory architecture put in place post the 2008 financial crisis has worked as intended. Banking in 2020 has been part of the solution, with a critical role in supporting economic recovery. However, there have been some unintended effects and examples of regulation not working as intended.

Examples of regulatory headwinds for banks looking to support the European economy include:

- *Capital conservation buffers* – These additional capital cushions have not been as flexible as hoped. For many banks the calculation of running through capital buffers in the short term, knowing that they are likely to have to rebuilt them in a stressed economic environment, where capital will be more expensive, has not proved attractive.
- *Non-risk sensitive constraints* – As bank balance sheets have expanded to accommodate credit drawdowns and support government mandated loan support, so non-risk sensitive constraints such as the leverage ratio have risked becoming binding. Monetary policy interventions have also led to a growth of deposits across Eurozone banks, triggering increased contributions to the Single Resolution Fund (SRF).
- *Treatment of non-performing exposures* – New accounting rules under IFRS 9 risk magnifying the impact of the extraordinary challenge of the COVID-19 lockdown across Europe, whilst the capital treatment of securitisations (particularly of NPEs) means that easing the constraints on bank balance sheets remains challenging.

All of these aspects of the current prudential regime in Europe create incentives for banks to de-leverage, in line with a sharp economic contraction. This is the result of a design informed by the 2008 financial crisis and the need to discourage leverage, especially ahead of a recession. That design had not envisaged a situation like that of the COVID-19 pandemic. A fire sale of assets and lending freeze now could result in impairments for banks, harming the economy and undermining the resilience of the sector as a whole.

As the Financial Stability Board (FSB) noted in its July report, "policymakers should enable the financial system to continue to provide financing to the real economy under different recovery scenarios". The ECB expects the financing needs of the economy until 2025 to reach EUR 1.2 trn. For Europe, with only ca. 20% of new finance coming from capital markets, this credit will have to be provided by banks.

Fortunately the European authorities moved quickly to provide targeted and temporary relief from some of these pro-cyclical effects through the adoption of regulatory 'Quick Fix'. As the focus turns to recovery, however, a more sustainable solution will be required to ensure EU banks remain able to play an active part in financing a return to growth.

Additional action will be required. A small number of targeted changes should be sufficient to reflect the lessons of the crisis and ensure the regulatory framework remains fit for purpose – striking a balance between resilience and support for the economy:

- **Support for high-quality securitisation,** especially for NPEs, because it allows banks to monetise loan portfolios and share the risk with investors with the right appetite and recovery expertise, thus freeing up lending capacity. The EBA has already identified areas where this can be done safely without undermining the resilience of the banking sector.
- **Recalibration of capital buffers** to focus on counter-cyclical buffers (which have worked well) as opposed to capital conservation buffers where the sequencing of recharging the buffers is much less clear.
- **Tailored implementation of Final Basel III reforms,** to ensure European banks are not faced with the significant capital increase calculated by the EBA, especially as their internal models have proven resilient in this crisis.

Targeted changes can future-proof the European prudential framework so that European banks can provide the necessary financing for the economic recovery. That will be beneficial both for financial stability and sovereign finances.