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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. ●