SESSION SUMMARY - BERLIN SEPTEMBER 2020

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

1. COVID-19: a non-financial crisis which impacts the banking sector

A Central Bank official explained that a narrative of the crisis has been created based on two facts: the banking sector was not the origin of the crisis and banks are not part of the problem. However, the crisis is going to have, and is already having, an impact on the banking sector.

2. Immediate support provided by Central Banks to the banking sector to continue lending activity and transmit the monetary policy

Another Central Bank official pointed to the rapidity of the reaction - both by supervisors and central banks. Within the existing frameworks and mandates, they used maximum flexibility, which created immediate support. And also, the fiscal side came in. The supervisory action was mainly to give capital relief, and also to postpone a certain amount of initiatives and reforms that were still part of the implementation agenda of the previous crisis. Some forbearance was exercised in the burden that the banks would have in their reporting, and flexibility was used to deal with the procedure for non-performing exposures and loans. The most important aspect in the short term was the capital relief that was extended. There was even encouragement for the banks not to shy away from using these existing buffers.

A Central Bank official noted that monetary policy, fiscal intervention and credit guarantees introduced in more or less all European countries have also been instrumental in maintaining the flow of credit. An industry representative noted that banks reacted quickly to the COVID crisis by providing cash support to their customers, first with moratoria then with loans partially guaranteed by the state. A Central Bank official stated that the capital relief allowed the banks to continue their lending activity, and there were unprecedented levels of loans to companies. It was more subdued to households. For the corporate sector, a 7% increase month-on-month and year-on-year was reached due to this capital relief.

An industry representative noted that banks played a key role in the transmission of monetary and fiscal policy. A Central Bank official added that differently from what was observed during previous crises, this time an immediate credit crunch was avoided, as lending flows have been satisfactory during the crisis.

3. Policy makers need to address possible cliff effects triggered by the end of existing support schemes and the structural weaknesses of EU economies' unprecedented indebtedness levels

An industry representative noted there is a very significant increase in indebtedness, particularly across the corporate and the sovereign world, and an increase in unemployment rates. There has to be concern about the default cycle. The NPLs will weigh on the balance sheets of the banks.

An industry representative stated that the impact on banks will be significant and long lasting. The SSM estimates the impact of the crisis on banks' CET1 ratio to be between 1.9 and 5.7 points. The EBA also calculated that the COVID-19 crisis would hit European banks' CET1 from to 250 to 380bps. Banks are living a large-scale stress test, but there is adequate capitalisation and liquidity. However, the risk exists of a severe scenario which would need further measures from the authorities and further bank support to the economy. It is not the time to add new layers of capital requirements.

A public representative reinforced that banks' better liquidity, capitalisation and leverage served Europe well. It is essential to have a common European response that preserves the integrity of the single market, avoids national fragmentation and ensures that the financial sector can be part of the solution. In record speed the CER quick fix has been adopted to boost lending by up to €450 billion until the end of the year. Public authorities and supervisors have taken swift and decisive action. The green deal will need €260 billion of additional investment per year. Increased lending to citizens and business is needed.

An industry representative indicated that in the first half of the year bank capital ratios moved backwards by about 50 or 75 basis points, despite a material amount of regulatory forbearance. In the near term, stage one and stage two loans will go to stage three. That will provide headwinds for the banking system in terms of capital ratios.

A Central Bank official noted that the release of the counter-cyclical capital buffer contributed very little, due to the limited build-up before the crisis Euro area banks still face structural issues predating the current crisis. During the second quarter, the return on equity in the European banking system went negative. There has been an increase of provisioning, but still too few

loans were reclassified, and if banks are hesitant in reclassification there may be considerable cliff effects if the public measures stop.

4. Basel III and the lasting effort to clean NPL in the EU have been essential to reinforcing the banking sector

A Central Bank official noted that while in the past there have been discussions (and different views) around the Basel III regulatory reforms introduced after the global financial crisis, it must now be acknowledged that Basel III has been a very important step in reinforcing the banking sector and making it more prepared and resilient in the face of another crisis. The legacy NPLs had been reduced drastically during the previous years, and the most important reason for reducing the stock of NPLs was to be prepared for the next crisis.

5. EU economy recovery success factors

5.1 Structured and lasting support of the governments to corporates and economic policies conducive to growth and productive investments are essential

A Central Bank official indicated that the structural and growth-enhancing policies are extremely important for putting the (public) debt-to-GDP ratio on a declining trend, as well as for making possible an improvement of the corporate sector's economic financial conditions. That said, these are structural policies that will provide benefits in the medium term. In the short run, because of the current cyclical challenges, it is reasonable to expect that NPLs will increase in the coming months.

An industry representative noted that the corporates will help take people through the recovery process and get them back on their feet again. A corporate in trouble that has lost a great deal of turnover does not start by looking for new loans; it starts looking for liquidity saving measures. It is important, now that the economies may be starting up again, that there is the support of the governments and the private sector going forward.

A Central Bank official added, regarding bad loans and the quality of credit, that their evolution is inevitably linked to the macroeconomic outlook. The next generation of Europeans will have to pay back the debts that the Commission is now incurring, which underscores the importance of governments using these resources for increased growth, good investment and good debt.

5.2 Banks are essential to finance the economy during stress periods

A public representative stated that with the current crisis the completion of banking union and CMU is gaining even more importance. An industry representative stated that the crisis has shown that lending by banks is and will continue to be essential in Europe. Capital markets are not always there, particularly in stress situations, so the banks will be all-important for lending going forward.

6. Regulatory priorities

6.1 Dampening the RWA pro-cyclicality

An industry representative stated that with the pro-cyclicality of CET1 ratios the problem is with the pro-cyclicality of capital ratios, particularly around RWAs. In terms of the capital buffers applied in the capital stack, there should be a much greater proportion of counter-cyclical buffers.

6.2 Adjusting leverage and liquidity ratios

An industry representative noted on the leverage ratios that the classic response in crises, given interest rates are zero, if not negative, is going to be expansion of central bank balance sheets. The central bank reserves on bank balance sheets also expand, and there is the cyclicality in the leverage exposure in the midst of a crisis. There should be a serious debate about whether some of the temporary exemptions of central bank reserves from the leverage ratio need to be more permanent in nature.

6.3 Better communication on stress tests

A Central Bank official noted, regarding the pro-cyclicality of capital requirements, that regulators and supervisors have used all the space that current rules allow. Banks are reluctant to go into the buffers because of stigma effect, and until there is no evidence of a credit crunch, further action to push them to use buffers seems of little use, also in the light of the possible deterioration of asset quality in the next quarters. One thing that is important is the communication around the next EU-wide stress test, as there is a risk of giving conflicting messages (need to use buffers, on one side, and need to preserve them to face future shocks, on the other).

6.4 he short-term positive impacts on bank capital bases resulting from the general bank dividend restriction are challenged by an anticipated reduction of the access by banks to capital markets

A Central Bank official stated on the dividend restrictions that there was very strong support from the other political bodies, but it was a difficult decision for the private sector. Blanked dividend restrictions had been extended in order to maintain the capital within the banks, but there is awareness that such policy action could increase the banks' funding costs and thereby limit their capacity to fund the economy. It might have an impact on their access to capital markets at a moment when they are being encouraged to diversify the composition of their core capital and to issue more AT1s. It will make European banks less competitive, so this is a measure that cannot be prolonged for too long.

6.5 Digitalisation and fewer regulatory disincentives should favour the consolidation of the banking sector

A Central Bank official indicated that, also in order to face the profitability pressures, a process of consolidation might arise in the European banking sector. While supervisors have no role to play as planners of this process, it is important that the supervisory environment is at least neutral in terms

of consolidation. A Central Bank official added that the supervisor has no views on who should merge, as this was competition policy, but there is a case for consolidation as there is a problem of low profitability because of overcapacity, and banks doing too many things which are not profitable.

6.6 Securitisation shows important limitations although it should help to address NPL challenges

A Central Bank official indicated that the new securitisation proposals raise questions, because they imply new tasks for the ECB beyond its mandate foreseen in the Treaty. These tasks will put the ECB in a conflict of interest because, as a supervisor of banks, it wants to de-risk banks and keep risks off banks' balance sheet. Transparency and risk retention are a product surveillance activity and not prudential. There is an authority in charge of investor protection which would be a better fit.

A public representative stated that the prudential aspects can be neatly separated from the conflict of interest aspects. It is important that securitisation markets take off, but it is also important that there are actual transfers of risk away from bank's balance sheets, so it would be reassuring for the ECB to take a clear interest in promoting, regulating and controlling this. Additionally, next year NPLs will start skyrocketing, and there needs to be a debate as to whether a traditional "bad bank" is going to be the solution, especially given that now the bad loans will be corporate and SME loans and not collateralized mortgages. In this way, private and public sector players should start thinking of new approaches that would allow for a genuinely European solution, and not just "networks" of national AMCs.

6.7 Home host relationships and funding of bank resolution at the EU level should be addressed in order to make progress regarding the Banking Union

A public representative warns that the crisis is increasing differences between countries. That means the banking union is more important than ever, because these divergences will only foster the vicious circles between banks and sovereigns. As home and host regulators for cross-border European banks fight to ensure sufficient capital and liquidity in each market that a bank might operate in, solving the home/host issue will be particularly important in order to make progress towards a banking union.

A Central Bank official added that the faster the move to banking union the better with a central element being the introduction of a European deposit insurance scheme. Restructuring a bank is a government task, and monetary financing of a government task is not possible. Therefore, a guarantee from the ESM would be needed if the ECB were to provide liquidity

A public representative stated that the first two pillars of banking union, supervision and resolution, are delivering but the gradual implementation of the third pillar on European deposit insurance and progress on the regulatory treatment of sovereign risk are also needed.

6.8 No research is available to cover smaller or mid-sized companies seeking market finance

An industry representative noted that with MiFID II there is the issue of the unbundling of research costs. This has led to many of the smaller or mid-sized companies not being covered by research anymore, which means investors are not as interested in investing in them. A public representative stated on CMU that basic building blocks have been adopted but much remains to be done to ensure equal access to investments and funding opportunities.

7. The anticipated pro-cyclicality and cost of the forthcoming bank regulatory capital framework has to be addressed, taking both the global regulatory perspective and EU specificities

7.1 The low level of banks' profitability is a concerning weakness in the EU

An industry representative remarked that the resiliency of the banking system is not just a function of its capital and liquidity buffers but also of its profitability. Forward projections of profitability for the banking sector are in the range of 2-3% over the next two years. That is a reflection of an unhealthy banking system, and one that might be one more accident away from having material financial stability issues.

A Central Bank official noted that, when assessing the profitability outlook for the banking sector, one dimension to take into account is the increase in competitive pressures, especially due to technological innovations. More in general, there are issues of efficiency, economies of scale, overbanking and consolidation that have been present for some time; the experience related to the recent Covid-shock shows that there is a clear need to address them effectively as soon as possible.

7.2 The bank regulatory framework is pro-cyclical

An industry representative stated that the pro-cyclical capital framework aggravates the situation in downtimes, but most corporate customers across Europe are fairly small or mid-sized. It is not realistic for them to go out and get an external rating and have a listed security, which will be the requirement if they are not to be punished by the coming framework. If a new framework that actually punishes high-quality, low-credit risk companies is introduced, and the incentives are skewed towards less capital for high-risk ventures and lending, the situation will be different. The small and mid-sized companies, which are not rated and do not have a security listed, will not help in the move out of the crisis.

An industry representative stated that the 24% increase in capital requirements resulting from the transposition of Basel IV would freeze a lot of financing necessary for the recovery and the greening of the European economy. The amount is estimated at €7 trillion based on SSM assumptions. If there is a problem with dividends representing less than 2% of the CET1 of European banks, then that capital requirement increase has a huge problem. Before any transposition of Basel IV is considered, there should be a thorough analysis of the economic situation and an analysis of the impact of COVID-19 on the financial needs of the European economy.

7.3 Basel III is a multilateral agreement adopted in December 2017

A Central Bank official expressed support for the multilateral approach versus renationalisation or a

situation where everyone is trying to undermine the policies in other jurisdictions. This principle should also be supported beyond Europe, at international level. Re-opening Basel III would be the wrong discussion to have now.

Another Central Bank official emphasised from the Basel Committee perspective that the need to preserve multilateralism when defining the financial system framework is particularly relevant. The interrelations among the financial sector all over the world are huge. The full and consistent implementation of Basel III also needs to be preserved. It is inconsistent to say that banks have entered into this crisis in a much better position precisely because of implementation of Basel during the last decade and all of the financial sector reform, and to also question this implementation down the road.

An industry representative stated that the current situation is a real-life stress test that could not have been predicted, which is probably harsher than anything ever anticipated, and the absolute level of capital has so far been sufficient. There are concerns in terms of the pro-cyclicality of RWAs and the impact on the CET1 ratio. There is no major issue with Basel IV, but the extent to which this is a stock issue, or a ratio issue should be considered.

A Central Bank official noted that a distinction should be made between what is needed now in an exceptional situation and a steady state situation. This unprecedented situation has seen prudential authorities relaxing some requirements and encouraging banks to use all buffers to the full. That banks' capital buffers and capital requirements have been built up during the decade has been one of the very important foundations of their ability to withstand the crisis. It is right to be flexible in the short term. It is also right to be rigorous in the steady state, including the completion of Basel III. It is important to remain committed to the strengthening that has been decided at an international, multilateral level.

An industry representative noted that even though banks have been stronger than going into 2008, they are not immune to problems in the real economy. Delaying or phasing in new requirements will give banks time but is not sufficient. A framework that is properly risk-sensitive is sought, because it is very clear that capital is there to bear losses when they occur, and losses are inevitably driven by risk and nothing else. Financial services are increasingly supplied by institutions other than banks, which do not have the same rules as banks, are not supervised like banks, and do not have internal governance, capital and liquidity. In order to preserve consumer protection and financial stability, the same regulation is needed, irrespective of who the provider is.

A public representative added that the global standards need to be implemented in line with Basel by January 2023. Good care must be taken of Europe-specific business models, and that is the responsibility of the European Parliament and the Council. ■