BASEL BANKING STANDARDS EVOLUTION

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Building resilience of the EU banking system through regulation

The Global Financial Crisis evidenced clear shortcomings in the regulatory framework that the BCBS aimed to address with the Basel III reforms, notably by improving the quantity and quality of regulatory capital, setting up a new global liquidity framework and introducing macroprudential elements. Included in the wide-range set of support measures taken during the current crisis to support the economy and preserve financial stability, additional relevant initiatives have been adopted at the regulatory level, some of them on a temporary basis. In this context, (i) the amendments of the EU regulation anticipating some of the flexibility embedded in CRR2 and implementing transitional provisions to defer impacts in a context of higher uncertainty, (ii) the EBA clarification on the flexibility embedded in regulation regarding default and forbearance, and (iii) the flexibility provided on the use of capital buffers should be particularly highlighted.

The Covid-19 crisis has stressed the importance of having prudent standards. Thanks to the progress in building capital and liquidity buffers, most banks continue, as of today, to meet the minimum capital requirements. Moreover, most of the regulatory relief measures taken since the outbreak of the crisis made use of the flexibility available in forthcoming Basel standards or were granted using transitional arrangements.

But the pandemic crisis is not over yet. As the situation evolves, more information on the impact of the pandemic becomes available but the level of uncertainty is still high. While assuring that banks rigorously reflect credit risk in their balance sheets, both regulatory and supervisory authorities need to continue following a consistent approach. In a context where temporary relief regulatory measures set to incentivize banks to finance our economies and absorb losses are still in place, flexibility should not be offset by conflicting requirements that could lead to a sudden halt of credit supply and magnify bank losses.

The adequacy of the international banking regulatory framework is also being tested for the first time in crisis times. While some debates emerged over the last year, for example on whether existing releasable capital buffers were adequate and sufficient in crisis times, it is too early to evaluate the effectiveness and resilience of the Basel III framework. Only in a few years, it will be time to take stock of the lessons learned.

The adoption of the latest Basel III reforms has been delayed and it raises some challenges in the current juncture. However, even if some additional transitional arrangements, beyond those already envisaged for the output floor, may be needed, the adoption of those standards in the EU should not be jeopardized or weakened. Notwithstanding short-term priorities, it is important to ensure the return to normality in regulation, implementing the reforms in a gradual manner. Basel III standards are a structural piece of the prudential framework to continue strengthening EU banks and make them better prepared to face future crises. Failing to fully and consistently implement the standards may have a detrimental impact on the resilience of the EU banking system in the long run.

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How should Basel banking standards evolve now?

Banks faced the pandemic crisis in a significantly stronger capital and liquidity position than they had at the onset of the Great Financial Crisis (GFC), also thanks to the Basel III standards adopted in response to it. For this reason, the international banking system acted as a shock absorber rather than amplifier and kept lending to the real economy.

The positive role of banks in dealing with the crisis has also been facilitated by far ranging measures taken by the supervisory community under the aegis of the Basel Committee. The Committee encouraged banks to fully exploit the flexibility embedded in the prudential standards on capital and liquidity buffers making clear that a measured draw-down of such buffers in time of stress was appropriate. The same encouragement was made with regard to the use of the flexibility in the accounting framework. Further, the Final Basel III standards was deferred by one year, to 2023. The overall effect of such measures will be subject to a continuous monitoring by the Committee.

The dramatic events of last year underlined the importance of having a

resilient banking system supported by a comprehensive and effective regulatory framework. The latter needs to evolve to keep up with the challenges that the financial sector will face in the future. Looking ahead, the regulatory agenda should focus on the implementation and evaluation of the reforms adopted in response to the GFC as well as on how to deal with emerging issues.

Notwithstanding the flexibility granted by the Basel Committee, the latter called the supervisory community to a full and timely adoption of the Basel standards at a national level. Furthermore, having in place the revised prudential framework will also facilitate the Committee in evaluating whether the new prudential framework has achieved its policy goals or whether there is still room for a fine tuning or simplification. The evaluation process will also shed light on whether the new regulatory framework is ready to address also the structural changes that will emerge in the 'post-Covid 19' environment.

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The more forward-looking line of evolution refers to how the regulatory agenda should deal with emerging risks such as those posed by the ESG framework and the FinTech evolution.

On the former aspect, works should continue to assess how to adequately incorporate ESG factors in the prudential framework.

On the latter, the pandemic has shown the large potential benefits of the increased digitalization of the economic environment. The banking business and the financial sector in general made no exception to this trend. The regulatory framework should evolve to keep up with the spread of technology-enabled innovation in financial services in order to develop appropriate safeguards to deal with such new risks, such as cyber risks. An additional challenge for supervisors and regulators is also posed by the potential impact of the Fintech environment on banks' business models, as the competition in the provision of certain financial services is rapidly increasing. While still tackling the emergency, global standard setters such as the Basel Committee should be ready to look beyond the crisis and start a comprehensive discussion on future trends and challenges in banking and finance.

OTHMAR KARAS

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Making financial markets work for the future of Europe

It has been over a year that we have been gripped by the Covid-19 pandemic and its profound impact on our lives, economy and financial markets. The European legislator has continued to function through all these difficulties. While many important measures have been adopted, we need to learn the lessons to be much better prepared for future shocks. At the same time, we need to complete our common projects to realize a genuine EMU.

Clearly, the financial markets are part of the solution in dealing with this crisis. We must continue to create suitable frameworks so that the financial sector can effectively contribute to optimal financing conditions for citizens and companies. On the road to recovery, we have already made important steps. On the one hand, we have adopted in record speed targeted banking rules to mobilize 450 billion Euros in fresh loans. On the other hand, we have realized a comprehensive recovery package for the capital markets.

However, key building blocks still need to be put together. Our effort to complete the EMU yields a high return: The EPRS estimates the added value of a complete Banking Union, a stronger CMU and closer fiscal policy coordination to be up to 275 billion Euros per year. At the same time, we need to make the financial rules future-fit. Let's just think about digitization, sustainable finance and the expected rise of NPLs and bankruptcies. Also, "Next Generation EU" can be more than a recovery fund: It is a forerunner to new shared fiscal tools to complement our monetary policy.

Our Banking Union is only as strong as its foundation. We must continue to implement global standards while taking account of European specificities.

Our Banking Union is only as strong as its foundation. I strongly welcome that the BCBS has postponed the implementation of the finalisation of Basel-III to increase the capacity of banks and supervisors to support our economy. Even though Basel-III is postponed, it is not off the table. We must continue to implement global standards while taking due account of European specificities. Both, in terms of a primarily bank-financed economy and in terms of the different business models. Because in Europe, the diversity of our banking landscape is a strength.

What the European Parliament has adopted in November 2016 still applies today: "no significant increase in overall capital requirements". In this context, some elements must remain undisputed in my view: the stronger SME Supporting Factor and the CVA exemption. At the same time, concerning the Output Floor – our "elephant in the room" – all options remain on the table as long as we achieve a Basel-compliant solution that implements our common goals. European solutions are also needed in the areas of equity investments, un-rated corporates and specialized lending. And we need to move forward on capital and liquidity waivers to improve the integration of cross-border banking groups.

2021 also marks the start of the debate about the Future of Europe. This is much more than an answer to crisis. It is about the vision to actively shape our common future. And it is about realizing what we have already planned to do – such as deepening the EMU. Let us be ambitious and bold. And let us always be aware that Europe is all of us – citizens, politicians, stakeholders, regions, nations. We all share the responsibility in further developing a strong, efficient and credible EU in the world.

GOTTFRIED HABER

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Lessons from the Covid-19 pandemic and how regulatory banking standards should evolve

In response to the Covid-19 pandemic European authorities acted swiftly to help mitigate the impact on the economy, secure lending and ensure a smooth functioning of the financial sector. Coordinated policy measures comprise fiscal public support measures, public loan guarantees and moratoria, monetary policy interventions as well as capital, liquidity and operational relief measures enacted by banking supervisors. In addition, compared to previous crisis European banks entered the pandemic with significantly higher capital levels and more stable liquidity and funding positions. As a result, banks so far could cope well with the current economic deterioration. However, the impact of the pandemic on banks' balance sheets is not yet fully evident as several support measures will phase-out during 2021 and credit impairments materialize with a time lag.

Banks have responded to the pandemic by pursuing strategic overhauls, implemented restructuring programs, and in some European countries the pandemic has started a long overdue consolidation in the banking sector. In addition, the pandemic has accelerated innovation projects and digitalization. However, banks are expected to strengthen their reporting framework as with the increasing use of technologies timely and accurate data will become even more important in the future.

The future regulatory agenda needs to focus on a comprehensive and risk adequate inclusion of future risks like digitalization, data issues and ESG.

How will the post COVID-regulation look like?

First of all, regulators will have to phase out the temporary COVID-19 relief measures and restore pre-COVID-19 regulation standards. While some simplifications might be warranted in this respect, regulatory and supervisory standards should remain on high level. Second, the remaining Basel III reforms need to be implemented in a timely and consistent manner in the EU. Moreover, considering the lessons from the pandemic, an evidence-based evaluation of the effectiveness of the already implemented Basel III framework, especially the usability of capital buffers, should be conducted.

Third, future developments in the financial sector need to be tackled. New risks from the ongoing digitalization in finance should be reflected in the regulatory framework. ESG (Environmental, Social and Governance) risks are another topic, which must be incorporated into banking supervision in the coming years. However, isolated regulatory initiatives regarding ESG risks in the financial sector will not be sufficient to address climate change. These initiatives must be embedded within a holistic, cross-sectoral approach based on the comprehensive European Green Deal. It is important to focus on a true and accurate inclusion of such risks on a risk-by-risk basis and within the context of existing risk models.

In addition, supervisors themselves need to make better use of digitalization as regulatory and supervisory technology has tremendous potential to improve analytic capacity and quickly scan for unusual developments.

Banks and regulators are in this together: Like the banking sector, regulators must adapt to a changing environment. Regulation must evolve constantly to ensure a framework which addresses new developments and changing risks appropriately. But, changes in the regulatory framework have to be decided upon sufficiently in advance in order to ensure stable expectations and smooth adoption.

PHILIPPE BORDENAVE

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What are the policy mistakes to be avoided, to foster a stronger economic rebound in Europe?

One year after the unprecedented Covid-19 lock-down, a lot of lessons should be learnt from the policy responses that have been implemented by political and regulatory bodies in Europe. They should help Europe to choose the right way to foster a strong economic rebound.

In parallel with unprecedented fiscal and monetary stimulus, regulators, at international and European levels, decided targeted and temporary revisions to the accounting and prudential frameworks, to allow banks to channel fiscal and monetary support programs to the economy.

Those measures have indeed alleviated the consequences of the pandemic on banks' balance-sheets, but, at the same time, they are the testimony that regulatory requirements were too high, and too pro-cyclical, as banks had argued for years. The EU had also over-transposed international standards: solo application of capital and liquidity rules, EU specific buffers, MREL requirements above TLAC levels, contribution

to deposit guarantee scheme AND resolution fund, ...

Setting excessive, non-flexible levels of capital in good times, to discretionarily relieve pressure in crisis times is not a healthy nor sustainable regulatory regime. Indeed, stability and predictability of regulation are crucial for economic agents like banks to set dynamic strategies and invest over the longer term. Contra-cyclical flexibility has to be built-in and transparent.

Excessive levels of capital and liquidity requirements during good times are counterproductive. They constrain banks to curb lending to the economy, which affects investments and competitiveness. Banks' balance sheets may be extremely robust, but growth is subdued, and economy is more vulnerable. This in turn leads monetary authorities to lower rates, which deteriorates further banks' profitability, and investors' appetite to invest in bank equity and debt securities.

Now should be the time to relaunch the economy.

There are currently no signs that the EU has recognized the risks of this approach. Instead, the EU is considering a costly transposition of the "final Basel III" rules, which, as per the Basel Committee itself, only hits European banks, with a +18.5% increase in capital requirements. Such combination of continued downward pressure by low rates on banks' capital generation capabilities, and of upward pressure on regulatory capital requirement will dampen the EU economic recovery, aggravating the EU growth deficit compared with the US and China.

In this context, it should not be a surprise that European banks have become unattractive as compared with US banks or with other EU sectors. Such perception by investors has been further anchored by the decisions on dividend distributions, where the supervisors solemnly "recommended" not to apply the Minimum Distributable Amount (MDA) rules that had been carefully designed at international level and voted by European co-legislators in the CRR!

Now should be the time to relaunch the economy. With banks balance sheets having been reinforced for more than 10 years, regulators should allow banks to fully deploy their lending capacity rather than devoting their efforts to comply with additional and ever-changing regulatory constraints.

JAMES VON MOLTKE

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European banks after Covid – Challenges and opportunities for the years ahead

The Covid crisis saw a remarkable turnaround for Europe's banks. In 2008-9 they were part of the problem; through Covid, they were part of the solution, deploying much-strengthened balance sheets to maintain the flow of financing to the EU economy. Loans to companies are expanding at the strongest pace since the financial crisis (+5.5% yoy in December 2020), while retail lending also maintained its solid momentum (+3.2%).

A year into the crisis, Europe's banking sector has proven its resilience, with a total capital ratio above 16% and liquidity well above 100%. Banks are well placed to continue to play a vital role in Europe's recovery. Two priorities stand out. First, dealing effectively with insolvencies and other impacts of withdrawing government support; second, seizing and supporting opportunities to boost growth.

Regarding the first: the impacts so far have been contained. Non-performing loans have not risen appreciably as government measures are still in place. They are expected to rise in 2021-2022, although with important local differences as the economic impact and scope of government support both vary across different nations.

As we re-build after Covid, Banks can play a vital role in setting Europe on the path to growth.

So far, flexibility on all sides has been key – for example, through moratoria or other forbearance measures. Going forward, this is vital; entire sectors will need restructuring to become viable. Working with clients to identify workout solutions has proven successful, and regulation needs to enable this to continue. Excessively onerous capital requirements on non-performing loans would have the opposite effect: forced asset sales, collateral enforcement and insolvencies, and thereby choke off the post-Covid recovery.

Regarding the second: a clear path to competitiveness, innovation and growth is vital for Europe. Digitalization and the transition to a low-carbon economy both offer significant opportunities; however, both require financing on a scale which goes beyond conventional balance sheet lending – still the dominant source of financing for most European companies. Here, too, Europe's banks can play a central role, but two factors will be decisive.

First: further progress on banking union and capital market union. This will spur consolidation in the banking sector and help Europe's leading banks close the 'scale gap' to their US and Asian peers. Enabling Europe to develop deeper capital markets helps finance economic growth and creates opportunities to boost returns for savers and investors.

Second: a regulatory level playing field. This is all-important as Europe completes implementation of Basel III. If we raise capital requirements for lending, Europe's businesses, particularly smaller companies, may find financing more expensive or less available at a critical time in our recovery. The high impact on large banks may translate into higher cost across all types of financing.

Europe's path ahead is clear. We will only make progress on that path by working together. Governments, regulators and banks came together and worked in partnership to steer Europe through the Covid crisis. Let's keep that partnership spirit as we set the course for recovery, competitiveness and growth.

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We need to breathe

During the covid crisis, banks have been part of the solution, together with the support of monetary and fiscal policies. They provided liquidity to the European businesses and households, to bridge their cash needs when the economy stopped due to the pandemic. This has been crucial, because the European financial market is too small to substitute banks' ongoing external financing. Banks have enough liquidity and capital to weather this "live" stress test, as recognised by supervisors (SSM vulnerability analysis, July 2020).

So far, the impact of the economic crisis on banks' balance sheets has been limited. It is no wonder, since public institutions absorbed most of the shock. They were indeed the only ones able to do so, due to the nature and magnitude of the crisis. Bankruptcies and NPL have not soared. For the time being, most of the impact on banks comes from the ex-ante provisioning of possible risks.

In any case, banks will absorb part of the shock. However, the materialisation of these risks depends on public policies. The pandemic crisis is not over. We still need strong support from public authorities to back the economy and the most affected businesses. If this occurs, casualties will be limited. In the meantime, pessimistic forecasts feed old habits: self-protection, mistrust and the comeback of the usual bureaucracy. The implementation of Basel IV is especially worrying. Indeed, the Commission plans to release its draft legislation next July, in the middle of the economic crisis.

All we need is appropriate implementation, respecting the political mandate.

First, legislators should not transpose the Basel agreement until the EBA has completed a deep analysis to provide the full picture of the Covid impact on banks. An estimated impact by supervisors of between 200 to 800 bp on solvency ratios confirms that additional capital requirements may destabilise the financial sector by seriously narrowing capital buffers European banks now have over regulatory minima. The trick of a long phasing-in has already proved its inefficiency in in the past, since markets always priced a fully loaded approach of regulations such as Basel III.

Second, at the very time when Europe needs financing to continue supporting businesses and to support the green and digital recovery, this reform would freeze hundreds of billion euros representing a financing capacity of thousands of billion euros, with no possible compensation by the financial market.

As supervisors have repeatedly said that the capital level of European banks is adequate, the urgency is not to increase it further. Rather than finalising the answer to the previous and different crisis, we should try to solve the present one, with timely solutions. Americans are pragmatic. They are faithful to the political mandate of no significant increase in capital requirements. They said they would stick to it, noticeably for FRTB. This will not hamper their recovery.

Third, Europeans are not lagging behind as regards prudential regulations! They have gold-plated

Basel III with pillar 2 and MREL. Another layer of gold plating is not necessary. All we need is appropriate implementation, respecting the political mandate of not significantly increasing overall capital requirements, and not resulting in significant differences for specific regions of the world.