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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.