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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.

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.