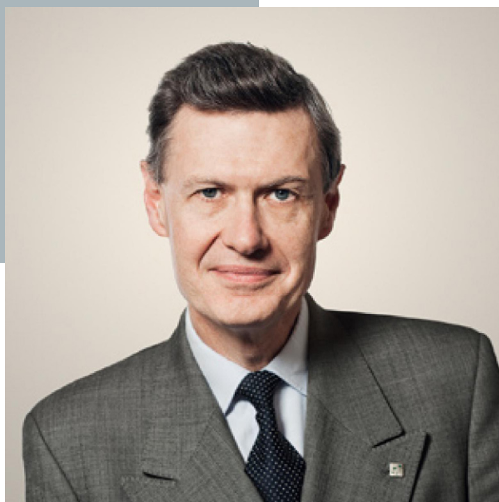

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What are the policy mistakes to be avoided, to foster a stronger economic rebound in Europe?

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.

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.