# EXIT FROM COVID MEASURES

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## Exiting from Covid-19 measures: policy challenges and the impact on EU banks

The EU banking sector has shown remarkable resilience over the pandemic crisis. In the future, however, EU banks will still have to cope with high uncertainty related to the economic recovery and the impact it will have on the financial system.

The latest stress test conducted by the European Banking Authority confirms that the euro area banks are able to withstand a crisis even under severe assumptions. This hinges, among other things, on the mitigating impact of the public guarantee schemes and their continued positive impact on credit risk parameters.

Clear signs of vulnerabilities continue to affect traditional banks with high dependency on net interest income. With this in mind, a considerable gap remains between euro area and US banks on how they are perceived by investors, as testified by the significant difference in the price-to-earnings ratios. US banks recovered faster and continued to improve suggesting greater prospects for the near future. This is – at least partly – explained by the uncertainties surrounding the recovery in Europe.

Although the immediate danger in the private sector has been averted, the exit from Covid-19 measures poses several policy challenges.

First, legacies from the pandemic need to be tackled in the best way to preserve sufficient lending capacity. The amount of legacy Non-Performing-Loans (NPLs) has been contained so far, but the economic outlook and implications of policy actions are still uncertain. In line with the results of the stress test, there will be a need to address the NPLs emerging from the pandemic efficiently, maximising the residual value. The European Commission has proposed an NPL action plan, which outlines ambitious reforms and measures to mitigate the build-up of new NPLs both at national and European level.

*Exiting Covid-19 measures poses challenges despite dangers in the private sector averted so far.*

Second, the timing and sequence of withdrawal needs to be well calibrated. On the one hand, a premature withdrawal of regulatory and government support could turn viable banks and companies into non-viable ones, which would destroy the capacities that are pivotal for a fast and sustainable recovery. On the other hand, extended support of non-viable firms and banks can lead to misallocation of financial resources and slower economic recovery. Tensions may arise among the "optimal" regulatory responses – given the interplay among government, regulatory and monetary policy measures in support of credit extension. Coordinating this interplay will require extraordinary efforts. Different assessment of risks or structural changes and inexperience in withdrawing the support measures can complicate matters.

Third, exiting from these pandemic measures also opens the door to defining a new state of the banking sector. The pandemic provides some lessons on how to best deal with certain regulatory measures such as prudential buffers, which can now be taken on board. At the same time, the phasing out of the pandemic policy measures will also interact with the ongoing regulatory developments, such as the implementation of the final Basel III package and full implementation of the revised Bank Recovery and Resolution Directive (BRRD).

Exiting from these policy support measures is not in itself conducive to the long-overdue structural changes in the EU banking sector that would secure banks' ability to support growth going forward. The completion of Banking Union – with its EU-wide coordinated approach – will help to create the right incentives for banks to implement these structural changes and reduce their related adjustment costs.

The treaty reform of the European Stability Mechanism with the early introduction of the common backstop to the Single Resolution Fund, brings us closer to completing banking union. This backstop serves as a supplemental safety net as it can lend funds to the Single Resolution Fund to finance a resolution in case failing banks deplete the Fund's resources.

However, several important building blocks are still missing. Key elements for the completion of Banking Union is the proper functioning of the crisis management framework and a common deposit insurance scheme. A European deposit insurance would facilitate further financial integration across Europe. Europe will be best prepared for any future crisis only if it is equipped with a strong and uniform protection and crisis management framework. Strong political commitment to pursue greater legal and institutional harmonisation and centralisation will be necessary to make that happen.

FRANCESCO MAZZAFERRO

Head of the European Systemic Risk Board Secretariat (ESRB)

# The gradual withdrawal of support measures and implications for systemic risk

In the spring of 2020 EU Member States took a wide range of support measures to dampen the impact of the coronavirus (COVID-19) pandemic on the economy. These mainly took the form of public loan guarantees, direct grants, tax reliefs and loan moratoria. Non-financial corporations (NFCs) and households have been the main beneficiaries of these measures which, at the end of March 2021, amounted €1,329 billion (9.3% of EU GDP for 2019). In May 2020 the European Systemic Risk Board (ESRB) issued a recommendation to national macroprudential authorities to define a framework for monitoring the impact of these support measures on financial stability. It also asked national macroprudential authorities to submit data to the ESRB, which has since carried out its own analysis.

One of the ESRB's main concerns at that time was the possibility of cliff effects from the simultaneous withdrawal of many support measures in the fourth quarter of 2020, which could have led to a sharp deterioration of banks' asset quality and hampered the recovery if measures were withdrawn before the economy had been able to fully recover. However, these concerns have been alleviated as support measures were broadly extended. As a result, our latest data indicate a gradual withdrawal of support measures through 2021 and 2022, which should in principle avoid cliff effects.

The gradual withdrawal of support measures may also affect the EU banking system. In the case of loan moratoria, we expect a gradual increase in the number of loans subject to forbearance measures, as banks may renegotiate the loans of troubled borrowers and the related European Banking Authority (EBA) guidelines have now expired. For public loan guarantees, the possibility of liquidity tensions in the NFC sectors as a whole seems small, as loans increased significantly during the first half of 2020 and deposits at banks are at an all-time high. The reopening of European economies should also favour cash flow generation, and the possibility of a large increase in non-performing loans now seems smaller than a few months ago.

> An optimal allocation of resources towards innovative and sustainable uses must be ensured...

However, some sectors of activity, such as hotels and restaurants, remain heavily affected and could require further support or face widespread restructuring. These are sectors with a significant number of small and medium-sized entities (SMEs), which may not have the resources to withstand such a prolonged period of distressed cash flows. As a result, the capacity of insolvency frameworks across the EU to absorb a large number of insolvencies in a short period could be put into question, particularly as insolvency filings were suspended for several months at the peak of the COVID-19 pandemic and SMEs are primarily affected.

Looking back to the dynamics of the support measures, European economies have moved from the reactive phase in crisis management[1] – which occurred during spring 2020 and where broad measures were taken to alleviate liquidity tensions and avoid large economic disruptions – to the reassess phase, where measures should be more targeted in scope and focus on the solvency of viable NFCs. This entails the daunting task of identifying which NFCs are viable in the new normal and, as such, merit further support and which ones are not, and thus should be subject to orderly insolvency procedures.

For financial institutions, supervisory and regulatory authorities across the EU took operational and regulatory relief measures to complement those taken by national governments. These measures included guidance on the application of IFRS 9, postponing several supervisory reporting requirements and allowing banks to exclude certain central bank exposures from the leverage ratio. There are good reasons to unwind these measures soon: (i) the public support measures taken so far have prevented the expected disruption from the pandemic on the European economy from fully materialising; (ii) the economic recovery seems grounded on a sound path; and (iii) the 2021 EBA stress test exercise has revealed that the EU banking system is in an overall strong position to absorb losses in a deteriorated macroeconomic environment.

Looking ahead, the expected recovery in the coming months should lead Europe towards the rebuild phase, but pockets of excessive indebtedness in viable NFCs still need to be addressed. Here, it is important that banks intensify their monitoring of borrowers so that they can identify possible vulnerabilities early and act on them swiftly. Moreover, an environment of low interest rates, despite recent inflationary pressures, should facilitate the debt servicing of borrowers in the coming years. In this phase, an optimal allocation of resources towards innovative and sustainable uses must be ensured in order to guide European economies to a dynamic macroeconomic environment that will also benefit the financial system.

*[1] For details on the three phases, see Figure 2 in European Systemic Risk Board (2021), "Prevention and management of a large number of corporate insolvencies".*

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# Exiting from COVID-19 opens the way for Basel implementation

Now that most people in the EU have had the opportunity to get vaccinated, we are facing less uncertainty about the period ahead. Growth figures for the second half of 2021 and for 2022 look promising, with many countries re-opening their economies. At the same time, risks related to COVID-19 remain, and the unique situation caused by this pandemic will continue to present uncertainties. Potential variants of the virus could delay the recovery, but we are much better prepared to address new challenges related to the pandemic than we were in early 2020. This means we are now in a position to allow ourselves to look ahead, and to outline the path to normality.

Following the Great Financial Crisis of 2008-09, policymakers and supervisors have been working hard to implement the lessons learned by reforming the Basel standards. This has resulted in banks holding more and better quality capital to absorb potential losses. As the COVID-19 crisis unfolded, the European implementation of the final set of Basel 3 reforms was put on hold. Although the pandemic did not alter the underlying reasons for addressing the remaining shortcomings in the prudential framework, the need to ensure that banks were able to support the economy justified this pause. During the COVID-19 crisis we clearly benefitted from the stronger position of the banking sector compared to the GFC. Thanks to their larger capital buffers, banks have been better able to provide corporates and households with the support they needed.

In addition to the better starting position of the banking sector, supervisors took timely a number of supervisory measures, which helped banks to continue to play their key role in the economy. We allowed banks to temporarily operate below their Pillar 2 Guidance (P2G) and the Liquidity Coverage Ratio (LCR), while also recommending to refrain from paying out dividends. As we move back to normality, we should think about how best to reverse these supervisory measures.

The ECB recently decided to repeal the dividend recommendation by the end of September and return to case by case assessments as part of the regular supervisory cycle. This is in line with our stance that the measures taken were adopted in exceptional circumstances and should be reversed once appropriate. Also, most of the operational relief measures have already been reversed. With respect to the relief measures that are still in place, we should be prepared to return to normality. For the measures related to the P2G and LCR, we have provided forward-looking guidance and they remain in place according to their logic. In particular, banks will not be asked to replenish their Pillar 2 Guidance too early in the capital cycle, and in any case not before end 2022.

**The COVID-19 crisis has demonstrated the importance of a robust prudential framework.**

We must indeed remain aware that problems in loan books may become more visible ahead, particularly as government support measures are withdrawn across countries. We should not be concealing these problems if they come. An important lesson from the GFC is that payment problems of customers and the buildup of NPLs should be tackled head on. Our immediate priority as supervisors is therefore to ensure that banks have a detailed understanding of the credit quality of their loan books. Management strategies such as loan restructuring and write-downs should be used by banks where necessary, taking also into account customers' interests. If NPLs do build up, the EU action plan on NPLs provides an important set of initiatives to address these.

As we exit from the COVID-19 pandemic, we should resume our work on further strengthening the prudential framework. It is therefore very much welcomed that the European Commission is expected to publish their legislative proposals for CRR3/CRD6 this autumn.

The COVID-19 crisis has demonstrated the importance of a robust prudential framework. Implementing the final Basel 3 reforms fully, consistently and timely in the EU is crucial for further strengthening the credibility of banks' capital requirement calculations.

Complying with these global standards also prevents a risky race to the bottom which could ultimately undermine financial stability. As the process to agree and fully implement the CRR3/CRD6 package is expected to take some time, strengthening future bank capital requirements should not affect banks' current efforts to support the economic recovery, as some have suggested.

With the EBA showing a continuing decline in banks' capital shortfall from the Basel 3 reforms, and the ECB demonstrating the long-term economic benefits of the package, we should strongly support a full, consistent and timely implementation of these prudential reforms in the EU.

LORENZO BINI SMAGHI

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# Three trends reshaping banking beyond the pandemic

On the exit path from the pandemic, banks will inevitably be confronted by tough questions on a host of key topics. Fears related to high debt levels and a potential wave of NPLs have already been discussed at length elsewhere. Similarly, questions regarding evolving prudential and normative requirements abound, with regard to the usability of capital buffers or the efficiency of forward-looking provisioning notably. Beyond these immediate issues however, the Covid-19 crisis has accelerated structural shifts that banks will have to tackle.

A first major shift is the structurally different policy mix that is likely to remain in developed economies. The successful use of fiscal stimulus in this crisis has increased the propensity of governments to push for more stimulative fiscal policy, as evidenced by the Biden administration's successive stimulus and infrastructure plans or by the Next Generation EU plan in Europe. Monetary policy strategy is also in motion; both the European Central Bank and the Federal Reserve have made significant changes opening to door to steeper yield curves. Macroprudential policies are set to play an increased role against this backdrop, with the risk of higher levels of counter-cyclical or systemic risk buffers, as well as sectoral constraints on lending. In the case of the euro area, climate considerations have, moreover, become an integral part of monetary policy. The result could well see banks benefitting from slightly steeper yield curves, and not least in the US as the euro area seems likely to be bound by a more hawkish stance on fiscal policy rules. On the other hand, the administrative and equity costs of macroprudential policies seem likely to increase and competition from non-bank channels could well intensify.

The three transitions of our time, namely climate, digital and way of life, have also been accelerated by this crisis: policies to mitigate climate change and adapt to it are gaining traction, especially in Europe where the financial sector is placed at the center of the effort. At the same time, the pace of adoption of digital in our everyday life has moved up a sizable notch. Finally, new ways of consuming (leasing vs. purchase, re-use…), and of working (remotely, as a contractor rather than an employee…) are also changing demand for banking services. These three transitions generate opportunities for banks in terms of financing needs, cost optimization and new products. They also add or reveal new costs such as climate transition risks, and cybersecurity risks, while generating agile new competitors to which incumbents must react.

**The pandemic has accelerated structural shifts that banks will have to tackle.**

Given the hardening of the geopolitical fault lines, sovereignty considerations are also gaining in importance. This trend is likely to magnify the changes brought by the three transitions, with an additional twist: the sovereignty factor will increasingly conflict with business and prudential considerations. Banks, as fundamental instruments of sovereignty, could well be caught in the crosswinds. Here again, agility will be key, sometimes with a rightsizing of geographical footprints to limit the number of possible frictions.

Indeed, several emerging developments already underline how sovereignty considerations may change banks' business environment. The prospect of central bank digital currencies is largely driven by fears for the sovereignty of money, despite the risks they may present, not least for financial stability. Sovereignty considerations are also accelerating the comeback of competition policies from the US to China, which may have a transformational impact on investment banks' clients and activities, while possibly also curbing some of the threats to incumbent banks from large technology companies.

On another front, the push for the relocation of certain industries in the US or in Europe has the potential, if sustained, to curb international trade flows in some sectors while requiring bank financing for industrial projects whose business case rests more than ever on public support.

The post-pandemic world is arriving fast, and banks need to meet the challenge.

CHRISTIAN CASTRO
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# Regulatory and supervisory approaches in the third phase of the Covid-19 crisis

The nature of the Covid-19 shock – exogenous, temporary and global – made it clear from the beginning the need of joint public and private efforts to help mitigate its potentially massive negative effects on the financial system and the economy. As such, policy responses from international, regional and national authorities, including regulatory and supervisory bodies, were central. The accompanying contribution from the banking sector clearly was as well.

Responses during the first phase of the crisis focused on maintaining lending the real economy, thus preventing a credit crunch with adverse feedbacks for all market participants. Regulatory treatments for relief measures such as moratoria and loan guarantee scheme were rapidly introduced.

As the crisis moved to a second phase, policy measures turned more selective and tailored to specific needs and sectors. Banks' own risk assessments also step up at the pace that more information became available. This was a dynamic process still in motion since the underlying risk factors, the effects of support policies, and borrowers' performance continue evolving as we speak.

At present, in a still developing third phase, and when the road to recovery is being paved, it is expected that regulators and supervisors will continue playing a key role. As in previous phases, decisions will not be free of trade-offs. A main one is the need to strike a right balance between continue strengthening the banking sector while providing enough flexibility for banks to help support the road to recovery. Against this background, to draw some early lessons from previous phases may be useful for this ongoing phase.

First, gradualism and adaptability seem to remain two sensible guides also in the current context. Economic prospects have improved but remain uneven among countries and sectors, and are not free yet of uncertainty or short-term reversals. In this context, exit strategies should still aim to avoid cliff-effects that may lead to pointed deteriorations in borrowers' repayment capacity. In particular, it would be necessary to accelerate additional support measures focused on those SMEs that have been able to get through the crisis, but their new level of indebtedness may hinder their future development.

**Regulators and supervisors should continue playing a key role to support the road to recovery**

Second, it would be appropriate to apply well adapted measures to the current extraordinary circumstances. Given the characteristics of the Covid-19 crisis, regulatory rules and supervisory practices thought to tackle fault lines from previous crises may not work that well this time. Non-Performing Loans (NPLs) is a prime example.

Affected sectors and assets are now different, with NPLs largely concentrated among SMEs – a very heterogeneous sector and mostly without much collateral, what justifies a differentiated treatment in comparison with other exposures such as mortgages and consumer credit. Regulatory frameworks should provide enough flexibility for banks to be able to differentiate among viable and non-viable companies, avoiding any 'automatism bias' in the regulation applicable to exposures classification, especially to SMEs. This will help viable companies to get access to the finance they need or to restructure their financial obligations.

Third, 'Covid-adjusted' regulatory approaches as the ones previously described can usefully be complemented by adequately graduated supervisory practices. It is well known that, to be effective, regulatory and supervisory efforts should go hand in hand. In this sense, it would be helpful to avoid a possible 'inertia bias' in the application of approaches that were aimed to address legacy issues from previous crises or that may be more suitable for normal times. A search for consistency between applicable supervisory approaches and Covid-adjusted rules suggests that provisions should in principle be allocated to exposures to non-viable companies, while refinancing of viable projects should be encouraged by avoiding undue penalisations.

More prospective measures could include a revision of rules affecting the usability of capital and liquidity buffers. Buffers were useful innovations in the regulatory framework in order to increase actual loss-absorbency capacity on an on-going basis, contributing as such to sustain credit to the economy. The Covid-19 pandemic have tested this and other features of the regulatory frameworks for banks. It would be useful to evaluate, based on solid analytical and empirical evidence whether there is room for improvements to maximise buffers' effectiveness in practice.

Ultimately, all these regulatory and supervisory actions should help to sustain credit, supporting the road to the economic recovery.

Credit availability is a significant factor explaining the viability of sustainable businesses, something very much linked to banks' own financial strength.

MARK GEISLER

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# Withdrawal of support measures is a fact and is necessary to return to normal

How far and how efficient is the EU financial sector being vaccinated? The vaccination is not based on messenger-RNA but on a complex recipe of European and local policies and measures, the global economic and geo-political situation, and above all, the trust and confidence of the people which is the engine of growth, development and consumption.

How can we ensure that the current shield is not hiding a more severe crisis to come? We must hope that the human vaccine and protective measures will be sufficient to eradicate, at least partially, the virus in the global population. We must also ensure that the global economy will recover properly over the short, medium and long term. The harder part can come once the effects of this vaccine vanish. Monetary and fiscal policies have shown a degree of effectiveness and the return to "normal" should be sufficiently well controlled. The economic vaccine should not have side effect, such as the so-called cliff-edge or cliff-effect. The EU regulations, the global situation (including trades, investment and state indebtedness) and the degree of confidence amongst the population are the key axis to properly recover and build the next chapter of our society.

The Policy Department for Economic, Scientific and Quality of Life Policies Directorate-General for Internal Policies of the European Parliament issued a study in March 2021 "Path to Recovery: Dangers of Cliff Effects".

The banks and the financial sector are looking for a stable and predictable environment: This is essential. From a regulatory and supervisory perspective, the banks anticipate, with a certain (low) degree of efficiency, the regulations to come. During the time of Covid, all the measures taken were focusing on the support to face the economic consequences of the crisis (fiscal, monetary and moratoria). All of these measures helped the banks to continue to operate to support investments and to diminish the consequences of the deteriorating situation of some of their clients. Despite the fact that many banks suffered from the crisis, especially on their profitability, globally the sector resisted well. It is therefore of paramount importance for the financial sector to ensure stability and predictability in the next "moves" of the policy makers. The banks are an element of stability this time! They were present to support, in close collaboration with the States, large funding of different industrial sectors to resist the crisis. This temporary artificial shield, based on large funding and public guarantees, will end soon or later. The danger that companies go bankrupt will have an effect on the banks but also on the states liabilities. Considering the danger of indebted countries, we may face the same situation as of 2010. The bank resolution burden is on the shoulders of the member states.

**The challenge is to avoid a cliff-edge effect that can jeopardize all the efforts accomplished.**

The current low (EUR) interest rate has a double effect. In the past, the intention of the ECB to lower the EUR interest rate was well understood at the time, but the intention was never to keep this level so low for so long. Today, it helps states to face the repayment burdens but our economic situation has worsened with the pandemic crisis. The ECB should anticipate – and it is certain that they do – the next moves. Again, the sky is not the limit and increasing, in a strict and managed way, the EUR interest rate could send a very strong signal to the financial markets that the situation is controlled and in the way to normalization.

The reduction of monetary and fiscal measures could be implemented for a series of economic sectors (financial sector and industries for instance) while, at the same moment, the cliff-edge effect has little likelihood to occur. One of the solutions is thus to ensure that the pace of withdrawal of crisis measures is closely aligned with the recovery of the economy. Financial markets have now recovered from 2020 and are more stable. Risk aversion (following the first lock-down of the population) is now better managed but cannot be considered as low. The banks are anticipating a second wave of bankruptcies amongst their more fragile clients.

Indeed, the term cliff-edge or cliff effect refers to a situation where a sudden small change leads to big problems. For companies, the effect is materialized when, for instance, a rating agency is downgrading the credit rating. The effect is that these companies may enter into a vicious cycle of downgrades due to their new poor abilities to get financed. Any sudden ending of the support measures may create a negative shock leading to an undesired increase of risk for the financial sector. One last point.

It is worth reminding that Europe is embedded in a global environment where our partners are also acting to exit the crisis in the best manner.

Close understanding and cooperation with other actors are another key point of success.