

Martin Merlin
**BPI-IIF International Bank
Regulation Forum**
03 December 2020
**Panel I: Impacts of COVID-19 &
What it means for Bank Regulation**

Scene setter

During the half-day BPI-IIF International Bank Regulation Forum, you will participate in a 50mins panel (the first one in the agenda) on “Impacts of COVID-19 & What it means for Bank Regulation”. According to the agenda, *“This session will focus on international regulatory responses during the global pandemic, along with whether, and if yes, how such measures are unwound. The discussion will include lessons learned from the pandemic and what that might mean for the finalization of the Basel III end-game, and to what extent global regulators will re-evaluate the post-Great Financial Crisis construct in the wake of COVID’s impact”*

Following a short introduction by the moderator, the four panelists (including you) will invited to answer in turn two rounds of questions, the first round focusing on the experience of the panelists from the COVID crisis and the second round on the future regulatory agenda in light of the crisis.

Your first question will focus on the EU policy response to COVID-19 crisis to support banks and whether this response has attained its objectives. Your second question will focus on where do we stand with the implementation the final Basel III reforms and what has changed in this respect in light of the crisis.

The audience will have the possibility to pose questions between the two rounds of questions. Participants are PBI-IIF members from the EU and the US and associated companies such as consultancies.

The panel will be moderated by [REDACTED], [REDACTED]. The three other panellists are [REDACTED]. You will intervene as the last panellist.

This briefing contains (i) speaking points for the two rounds of intervention (ii) defensives to answer potential questions from the audience. In the annex, you will also find the complete list of questions for each panellist sent by the moderator after the prep call.

Finally, note that Commissioner McGuinness will provide a 15-20mins keynote speech on regulatory developments in the area of banking and beyond at the same forum after your panel. Her keynote will provide a high-level view on several areas of interest, also including the immediate response to COVID-19 and the finalisation of the Basel III reforms, but also tackling our strategy to tackle NPLs, the completion of the Banking Union, deepening the Capital Markets Union and the Renewed Sustainable Finance Strategy.

Logistics: The event starts at 14:00 and your panel is scheduled for 14:20. You are invited to join ahead of time to ensure that the connections works.

LTT

First question from moderator [ca answer 4mins]: EU regulatory response to COVID-19 crisis and whether it has attained its objective

[COVID initial shock]

- Good morning, good afternoon everyone. It is a pleasure to be with you today, if only virtually.
- The first phase of the pandemic came at an enormous economic and societal cost.
- Yet the solidity of the EU banks enabled the sector to help manage the fallout of the economic shock, notably by providing liquidity to embattled businesses and households.
- I firmly believe that the post-financial crisis reforms have greatly contributed to the resilience of the sector. Improved capital and liquidity positions have been instrumental in allowing banks to step in to support their clients when the crisis struck.

[EU policy response]

- Nevertheless, as part of the Commission's overall policy response to the pandemic, we have proposed a number of measures to further support the sector in dealing with the pandemic.

- In April, the Commission has issued an Interpretative Communication, which confirms the regulatory flexibility highlighted by EU authorities and international bodies. It is meant to give more certainty to banks regarding certain aspects of the regulatory framework, and it encourages them to make use of this flexibility with a view to continuing to finance the real economy. It also asks banks to maintain prudent distribution policies.
- At the same time, we put forward a legislative proposal for temporary and targeted changes to specific aspects of the prudential framework. This “CRR quick fix” reflected pandemic-related decisions taken at international level as regards certain aspects of the Basel framework (in particular concerning the transitional arrangements for IFRS 9 and the application date of the leverage ratio buffer). The proposal also aimed to account for the impact of COVID-19 related public guarantees in the context of the prudential backstop to NPLs to ensure effective transmission of public support, as well as frontloading by one year certain measures already agreed upon in earlier legislation.
- Co-legislators have swiftly reached an agreement on these changes, which became effective on 27 June 2020.
- The SSM and the EBA have taken complementary measures in their areas of competency.
- Supervisors and regulators have thus provided ample flexibility to enable banks to be part of the solution to the COVID-19 distress and continue financing households and businesses throughout the difficult period, we are currently facing.

[Impact of the EU policy response on banks’ balance sheets and lending]

- The policy measures that the Commission and other institutions have taken were quick and decisive, and they were very much welcomed by stakeholders.
- In our view, they had an immediate positive effect by calming the markets as they reassured market participants that policy makers have both the willingness and the capacity to act.
- Recent market observations seem to confirm that these policy measures taken at EU and national levels since the beginning of the pandemic have broadly attained their objectives.

- EU banks' loans and total assets in general have been increasing during the first half of 2020. The results of the ECB's most recent lending surveys also indicate that lending conditions remained broadly favourable in the second quarter of 2020, even though they somewhat deteriorated in the third quarter.
- At the same time, banks' capital positions have improved. This suggests that the regulatory relief has more than just mitigated the impact that COVID-19 has had on banks' balance sheets so far.
- As regards NPLs, it also seems that we are still in a relatively good place so far. While gross NPLs increased slightly during the second quarter to 2.8%, this level is still relatively low if seen against the background of the slump in economic activity that has taken place. Of course, there is a risk that NPL levels may further increase, largely depending on the length and severity of the crisis and the extent to which Member States' support schemes might run out over time.
- We are constantly monitoring the evolution of the COVID-19 crisis and its impact on banks. If other measures will become necessary to ensure recovery, we remain committed to react swiftly and decisively.

Second round of question from moderator [ca answer 3mins]: Future Implementation of Basel III in light of the crisis

- Beyond the immediate crisis response and the preparation of the recovery, we must carry on with our work on structural shortcomings of our framework. An important aspect of the remaining reform agenda is the finalisation of Basel III.
- With the COVID crisis, we have postponed the implementation of the final elements of Basel III in the EU, for which we had envisaged adopting a Commission proposal in June 2020, also taking into account the one-year delay announced by the Basel committee.
- However, our commitment to implement those reforms has not changed. The issues addressed by the final Basel III rules, notably the reliability of internal models, remain as relevant as ever.
- Softening prudential rules on a permanent basis –via, say, a partial or diluted implementation of Basel III - would put at risk the resilience and stability of the sector, and could prevent banks from being part of the solution rather than the problem when the next crisis strikes.

- Of course, we will pay particular attention to European specificities, where an increase in capital requirements might have disproportionate negative consequences for some specific sectors, business models or activities. We stand ready to make adjustments where necessary and justified.
- For the two years, we have already taken several steps to prepare for implementation: amongst others, we have asked the EBA for technical advice, and we have conducted a public consultation and organised a conference on the EU implementation.
- What has changed with COVID-19 is the starting point from which banks will have to implement the final elements of the reforms. As we already stated publicly in our Communication of April 2020, will take into account the impact of the COVID-19 crisis on banks' financial situation in the impact assessment that will accompany that proposal.
- For that purpose, we have asked the EBA to update their impact analysis in light of COVID-19. We are expecting the EBA to deliver their report before the end of the year. It will then feed into our own impact assessment.
- As regards the timeline, unless there are any further developments at international level, we do not see room for further postponements at the present juncture.
- Taking into account the length of the legislative process in the EU, we do not have much room for manoeuvre if we wish to avoid significant delays compared to the new implementation date that was agreed by the Basel Committee.
- Taking this into account, our working assumption for the moment is that we will adopt a proposal in Q2 next year

Defensives for potential questions from the panel

[Guidelines on moratoria]

The EBA recently decided not to extend the Guidelines on payment moratoria beyond 30 September. This will unduly constrain banks' capacity to finance the real economy.

- The EBA's decision not to extend the Guidelines is the result of a difficult balancing act over the past months: to give greater flexibility because of the extraordinary situation but also not to amass problems for the future.
- An important consideration here has been the wish to avoid cliff-edge effects and the abrupt reclassification of loans benefitting from the treatment foreseen under the Guidelines.
- At the same time, ensuring continuing support by banks for their customers remains key. In this context, it is important to understand that banks can continue to provide this support through moratoria also without the Guidelines. These loans will then be classified on a case-by-case basis according to the usual prudential framework.
- The Commission services will continue to closely monitor the evolution, and follow-up with the EBA, if needed.

[Use of capital and liquidity buffers amid the crisis]

One area of key focus has been the use of capital and liquidity buffers, which the BCBS has actively encouraged. How do you assess how effective these measures have been and what is your sense of the challenges that banks face in leveraging such measures?

- Overall, the EU banking sector entered this crisis in a much stronger position than it did during the global financial crisis. Capital and liquidity buffers have been very effective in bolstering banks' resilience.
- However, it may be too soon to assess their effectiveness. Indeed the impact of the Covid-19 crisis still needs to be reflected in significant increases in bank losses, whilst bank lending to the real economy has held up reasonably well so far. In addition, the stress on liquidity stemming from the Covid-19 crisis has been so far less intense than during the 2008 financial crisis.

- In line with BCBS communication, the Commission, the EBA, the ECB and national competent authorities have communicated heavily in the beginning of the COVID-19 crisis to give comfort to banks regarding the application of the prudential framework, including on the use of buffers.
- Despite the attention on capital and liquidity buffers, there are concerns about whether banks will be willing to use their buffers. This attitude does not seem to be related to the clarity of the rules, nor to the policies of the competent authorities in charge of their supervision, but rather centres on
 - the concern that the use of buffers would trigger automatically restrictions on distributions, and, as a possible consequence, downgrades from Credit Rating Agencies which include in their monitoring the distance from automatic distribution restrictions;
 - the negative signal it could send to investors; and
 - the uncertainty around the situation of the economy and the quality of their assets in the coming months.
- These concerns are not limited to European banks, but shared by jurisdictions around the world. The Basel Committee is aware of these issues and monitoring buffer usability.
- In the current context of the second wave of the pandemic, the Commission shares some of the concerns voiced around buffers usability in a crisis and is open to consider possible solutions that would enhance the usability of buffers while maintaining the overall objectives of the buffer framework unchanged. The topic is discussed in multiple fora and the Commission actively participates in these discussions.

[Exit strategy on capital and liquidity buffers]

Looking forward to a post-pandemic phase, how do you envision going “back to normal” in regard to capital and liquidity buffers and the restoration of all traditional prudential requirements? How will that transition take place and how to avoid potential cliff effects?

- As we don’t know yet the full impact of the Covid-19 crisis on banks, and the extent to which banks will make use of their capital and liquidity buffers, we don’t know yet from which point to envision going ‘back to normal’ as

regards the restoration of capital and liquidity buffers. It is therefore too early to define a pathway to fully restore them.

- However, once the situation becomes clearer, competent authorities should set out a clear pathway for re-establishing the buffers in the medium term. A credible and clearly communicated forward guidance from supervisors and regulators will help avoiding potential cliff effects and should avoid harming a fragile economic recovery.

[Lessons learned for future policies on procyclicality and usability of buffers]

Looking ahead, are there initial lessons from this pandemic that might suggest areas for future policy work for global regulators? (e.g. factors that contributed to the liquidity crunch in March, the procyclicality of capital measures and liquidity, the design and usability of buffers, etc.)

- Primarily, the Covid-19 pandemic has confirmed that the regulatory reforms that have been put in place over the last decade were appropriate. It is partially due to these reforms that the banks can be part of the solution during the current crisis instead of being part of the problem.
- It has also been shown that the regulatory framework is sufficiently flexible if applied as intended.
- In areas where regulators and supervisors did feel that action on their part would be helpful, they acted decisively and quickly.
- All of this makes me hopeful that at the end of the crisis we can conclude that to a very large extent the current framework has performed well.
- That said, a comprehensive review of the macroprudential toolbox in banking is envisaged for 2022. This will be an opportunity to take into account the lessons learnt during the crisis on the usability of capital buffers. For instance, it will offer the possibility to reconsider the overall balance between structural and cyclical capital buffers, with a view to possibly increasing the flexibility of the framework in future crises.
- To conclude: It's early days. Given the great uncertainty regarding the coming months, it is too early to say if there are areas in which the COVID-19 would point towards adjustments of the framework. And it's also too early to say what form such adjustments might take.

[Expectations on NPLs and regulatory response]

What is the outlook for credit risk in the region? Although there have been serious concerns about an avalanche of bad debt we still have not seen worrying levels of NPLs. Is this just a matter of timing? How well prepared are EU banks to face a serious worsening of credit risk? What tools do authorities have to react?

- Over the past years, NPLs in the EU banking sector have consistently declined. However, in the first half of this year, this trend has somewhat reversed due to the COVID-19 pandemic. Gross NPLs increased to 2.8% in Q2 2020, up from its lowest point of 2.6% in Q4 2019.
- This increase was driven by reduced NPL sales and restructuring activities as well as new defaults.
- At the same time, NPLs would likely have been higher if governments had not enacted the many ad-hoc support schemes such as loan guarantees, debt moratoria or loosening insolvency standards to alleviate the liquidity difficulties faced by businesses and individuals.
- There is a risk that NPL levels may further increase, largely depending on the length and severity of the crisis and the extent to which Member States' support schemes might run out over time, for example due to fiscal constraints.
- Of course, banks are going into the crisis from a position of relative strength. But there is nevertheless a risk that a strong NPL increase would unduly constrain lending
- The Commission will therefore put forward a strategy to address COVID-19 NPLs as early as possible and prevent a renewed build-up of NPLs on banks' balance sheets.
- First, the Commission seeks to strengthen the development of secondary markets for distressed assets, so that banks have the possibility to reduce their NPLs by selling them to third-party investors. Improving the quality and comparability of NPL data as well as setting up a European data hub to strengthen market transparency and liquidity is the Commission's main line of action in this regard.
- Second, the Commission will assist Member States in the restructuring of banks' balance sheets, by providing guidelines for establishing Asset Management Companies (AMCs) for those Member States that wish to set up such vehicles on a national level.

- Third, the Commission will seek to further harmonise and contribute to robust insolvency and recovery frameworks across Europe.
- Fourth, the Commission considers that an exception to the general principles established in Article 32 of BRRD could be granted, so that public financial support for banks that are not failing or likely to fail is an option. In doing so, solvent institutions that are impacted by the crisis could be recapitalised. Naturally, such support schemes would have to follow strict conditions, e.g. that the support is adequate in size, limited in time and only covers temporary and Covid-related losses.

[Climate risks]

Beyond ensuring adequate management of climate-related risks, authorities in the EU have floated ideas about using the regulatory capital framework to provide incentives for green assets and products. What is the EU Commission view on this? How does the private sector react? What considerations should be taken into account when deciding the right policies on climate risk and the prudential framework?

- Work is ongoing on several fronts to explore ways to incorporate climate-related considerations into the prudential framework.
- First, in the context of the 2018 Action Plan, the co-legislators have agreed during the revision of bank prudential rules in 2019 to mandate the EBA to explore the prudential soundness of introducing a more risk sensitive capital treatment of “green asset” (so called green supporting factor). The deadline for the EBA report is in 2025.
- Second, the EBA is working on a report on how Environmental, Social and Government (ESG) risks could be included in the regulatory and supervisory framework for credit institutions and investment firms. The work is progressing well. The EBA has launched a public consultation earlier this month and is expected to finalise the report by June 2021.
- Third, in the consultation on the Renewed Sustainable Finance Strategy, we also asked about the need to incorporate ESG risks into prudential regulation in a more effective and faster manner, if a category of assets could warrant a more risk-sensitive treatment, and what could be done beyond prudential regulation to mobilise banks or banks’ governance.

- We are analysing the responses to the consultation and assessing different options.
- In terms of timing, there might be room to move before the publication of the EBA report, at least on a provisional basis. But any envisaged solution should be designed in a way that it does not undermine the work ongoing at the EBA and remains compatible with a risk-based prudential framework.

Annex

Annotated list of questions sent by the moderator

Moderator introduction [ca 5 minutes]

- The recent news about the prospect of the development of a Covid vaccine provides some hope for normalisation and the possibility that this colloquium can again take place in person next year.
- There has already been a lot of discussion of the unprecedented financial policy responses by authorities. The most recent FSB covid report to the G20 also provides an overview.
- The focus of the discussion in this panel today will be on the phasing out of the crisis measures and the regulatory agenda for the time after the pandemic.

First round of questions: [ca. 20 minute]

- Question for [REDACTED] [answer ca 4 minutes]: You were closely involved in the development of post crisis reforms and you have moved from developing the framework for GSIBs to running a GSIB. Did the international policy framework work as intended? Which reforms would you adjust in light of the recent covid experience? Do you have any concrete suggestions what policy makers might need to reconsider?
- Question for [REDACTED] [answer ca 4 minutes]: We came into the crisis after 10 years of building up bank capital and resources for resolution. If the stress-tests are right and banks are robust, then how much longer should we expect to see dividend/buy-back restrictions. Are these restrictions really supporting lending to the real economy? Where do you think will be the pain threshold beyond which banks cannot lend, given the risks?
- Question for [REDACTED] [answer ca 4 minutes]: One issue that was uppermost in the minds of many was market fragmentation across borders and sectors? What has been the experience during the pandemic?

Have you seen any evidence of market fragmentation – across sectors/jurisdictions?

- Question for Martin Merlin [answer ca 4 minutes]: Covid 19 is a massive crisis, in many respects more serious and more widespread than the GFC. Despite that we haven't seen any failures yet. Is this surprising? Do you think the EU's crisis response has attained its objectives?

Questions from the audience [ca.15 minutes]

Moderator introduction second round of questions

- The FSB agreed on five principles that should underpin policy responses to covid-19. These include 1) a commitment to act consistently with international standards, 2) not roll back reforms, and 3) to coordinate on the future timely unwinding of measures.

Second round of questions: [15 minutes]

- Question for [REDACTED] [answer ca 3 minutes]: Can authorities act effectively in line with these principles? Or do we need to be more radical and think about revising existing standards?
- Question for [REDACTED] [answer ca 3 minutes]: What do you think?
- Question for [REDACTED] [answer ca 3 minutes]: Wilson, what international coordination on exit strategies would you expect from the FSB and the SSBs?
- Question for Martin Merlin [answer ca 3 minutes] : What has the Covid crisis changed in the future implementation of the Basel III reforms?

Contact details

[REDACTED]