SESSION SUMMARY - BERLIN SEPTEMBER 2020

Should we be concerned about post-Covid financial stability?

A regulator stated that the headline question for the panel is whether there should be concern about post-COVID financial stability. Of course, there should, but the panel would be an opportunity to dig deeper into some of the economic and financial threats in the wake of the pandemic. It would form a stocktaking of what has been seen so far, what was surprising and what is to be expected.

1. Overall, the financial system has proved to be broadly resilient to this crisis to date, but the crisis is far from over

1.1 Despite the adverse macroeconomic impact of Covid-19, the EU banking sector has proved to be resilient

The first round of discussion would look more at the macroeconomic impact of the pandemic. At its onset, EU bodies, national governments, central banks and supervisory and resolution authorities took unprecedented action to support the economy and preserve financial stability. The EU financial system entered the crisis more resilient and better placed to sustain financing as a result of the G20 regulatory reforms in the aftermath of the 2008 crisis. In particular, the greater resilience of major banks allowed the system largely to absorb rather than amplify the macroeconomic shock.

A regulator saw that markets largely functioned as normal. However, there was some movement to cash and, despite expectations of strong global growth returning, the recovery has been slow so far and the economic impact will be felt over time. Another regulator believes that it was the swift and bold policy actions adopted by the authorities, including some unprecedented monetary and fiscal measures, that cushioned the global hit and safeguarded financial stability. A central bank official agreed that the global financial system withstood the shock well, thanks to the collective effort of the last 10 years and the forceful reaction of public authorities and central banks.

1.2 The impacts of the pandemic on the level of risks in the banking system

A regulator mentioned how there was a fair amount of activity to make sure that liquidity was provided where needed and an early assessment of risks to avoid excessive pro-cyclicality. Going forward, every bank must carefully reassess the risks in their portfolios and exposures and make provision for them. An industry representative explained how banks are doing just this, taking a more granular approach to the assessment of their clients, as different sectors of the economy are likely to have differently shaped recoveries. The German Mittelstand, for example, will see some problematic defaults. Overall, however, most sectors are well capitalised and do not exhibit any systemic challenges that will spill over into the financial system. Leisure and travel have more problems, so the exercise that lies ahead is to run these analyses and take a more differentiated approach to the various regions and segments.

Supervisors are always extremely interested in what exactly is being done to cope with over indebtedness and this regulator is more sceptical about the capacity of a Mittelstand dominated economy to absorb shocks. An industry representative agrees that these efforts are only a starting point, but likewise supervisors may need to use the banks and other financial industry players when evaluating risks, as their windows into the real economy.

Another industry representative reacted to the panic of the late first and early second quarters by taking some big impairments, in particular because of IFRS 9's forward way of looking at things. Since then, European and national authorities have done a lot to reassure corporates and private individuals. There was a big drop in GDP in Q2, but it did not really matter to the banks, because loans and salaries were still being paid. In fact, some very big corporates opened their lines to ensure access to liquidity. Banks saw an increase in deposits too, both from private customers and corporates. Some sectors did very well, for example agriculture and housing in Denmark, but there are indicators developing that show the recovery might be W shaped, with several major cities entering a second lockdown. There is a limit to how much the authorities can be depended on for support. On the other hand, participants are better prepared now, so perhaps there will be fewer disruptions to liquidity despite some credit losses.

1.3 The release of buffers contributed to keeping banks on supporting the economies

The second round of questions would centre on policy measures in the short and medium terms. A regulator started with the capital and liquidity buffer issues, which another regulator described as important components of the regulatory toolbox that had been applied over the past few months. Many other issues have to be considered now, such as insolvency applications and the danger of zombie companies. The first regulator elaborated that the application of key regulatory measures ensured the competitiveness and efficiency of the banking sector and its ability to replenish capital buffers in the future.

The EBA had encouraged supervisors and banks to make use of the flexibility embedded in the regulatory framework. Early in the crisis, one of the key questions confronting parties was whether the regulatory reforms had enough flexibility built into them to be applied to a downturn of this size, without creating pro cyclicality and a bottleneck in the delivery of funding. In this regulator's view, the release of capital and liquidity buffers early on sent a message to the sector and society in general that the banks were able to help in this process, but there are still some lessons to learn. In parts of the euro area, liquidity buffers had been built but could not be released. In other areas, they were not even in place. The situation was not homogenous, which led to the paradox that

buffers may have been released in parts of the economy whose need was not as great as others.

A regulator was keen to hear more from the panellists about the banks' usability of those buffers for relief. There was the sense that some were reluctant, sometimes because of a perceived stigma from stakeholders, at other times because they feared damage to their franchise. Supervisors have been providing more guidance on how long the buffers are expected to last, so all banks should count on taking time to rebuild them, with clear guidance on how to.

Another regulator acknowledged how quick and coordinated action from regulatory and supervisory authorities enabled some leeway in reporting and other requirements in the short term. They adopted a pragmatic and flexible approach, using the existing flexibility of the legal frameworks without undermining their credibility. The clear message is that the regulatory framework is fit for purpose. The framework has proven itself, otherwise the banks would not have been part of the solution. The regulator concedes that the SRB could not postpone Single Resolution Fund contributions since the SRB could only apply the legal framework in force.

1.4 The economic and financial outlook is still largely uncertain

The Covid 19 pandemic constitutes an unprecedented global shock. At this stage, its full and final impact is not known. A regulator gave the latest ECB forecast as a GDP decline of 8.7% across Europe but, whether the downturn turns out to be mild, medium or severe, it will raise concerns for both the real economy and financial services. Another regulator stated that all were confronted with large uncertainty about the speed and strength of the recovery. Many have moved from saying that it could be very quick to saying it may not be at the same speed in different parts of the world or of Europe. Another regulator detects a drop in V shaped predictions; the majority of market participants now anticipate a W or U. The view from another public decision maker is that they might need to stretch the alphabet further.

1.5 Regulators need to continue to work intensively with their EU and global counterparts to address common challenges, share insights on respective market developments and coordinate responses where appropriate

The crisis has demonstrated the value of close and pragmatic cross-border coordination between regulators. One regulator reported how peers are already looking to what lessons we can learn from this crisis. The FCA, together with its international regulatory partners, including within the Global Standard-Setting Bodies, FSB and IOSCO, are looking at what has happened during the pandemic, including the early phase and the impacts of national lockdowns on the markets. Where it sees pressures, they are acting. However, to inform longer-term responses, the FCA, together with other regulators, are developing a complete picture of how elements of the system - , banks, non banks and market infrastructures - are interconnected and how they function under extreme stress, and then potential vulnerabilities can be identified and resolved in the future. Forming this holistic picture is a challenging undertaking, from a data and analytical point of view according to the FCA, as early evidence within this area of work suggests there are significant differences between jurisdictions, market segments and even firms and actors within the same sector. From the FCA's perspective, the markets are functioning well, and the system has proved itself resilient, but the crisis is not over, and the international community must continue acting together.

Another regulator followed up with the perspective from BaFin. Its biggest concerns came in mid March to early April, when there was less capital and indebtedness, so liquidity. Another regulator agrees that there was extreme volatility during this period and central banks stepped in to support the market. Early evidence suggests there were significant differences between jurisdictions, currencies and market segments, so it is difficult to draw firm conclusions, but there is a common sense that central bank interventions helped with market liquidity and reassured market participants. The issue continues to be explored carefully, as part of considering whether to take any further regulatory steps in the future. Another regulator emphasised that the cooperation evidenced between supervisors and resolution authorities this time must be repeated as they search for answers together.

2. Financial stability concerns are significant when it comes to the outlook for corporate indebtedness, asset quality and the profitability of the EU banking sector

2.1 Corporate debt ratios grounds for concern

A central bank official warned that no one should be complacent. There are a number of risks and liabilities ahead, which were reinforced by the first stages of this crisis. So far, corporate indebtedness has not transformed into a significant and destabilising insolvency shock for a number of reasons. The asymmetry of the macro impact of the COVID sanitary measures and those taken by the public and private sectors helped contain the liquidity issues. This has come at the price of increased indebtedness. An upturn in insolvency risk now could weaken banks' balance sheets resulting in slacker consumption and, in more extreme scenarios, greater credit risk.

There are a number of possible triggers of an increasing insolvency shock: a sluggish recovery, a double dip recession related to the management of the pandemic, the withdrawal of some of the measures taken to address liquidity risks and the end of the moratoria on social and fiscal debt repayments. From a financial stability perspective, it is important to support the capacity of the system as a whole and to strengthen the mitigants of risk. It is essential to support funding for corporates, not as debt but as equity. This is being addressed in many jurisdictions and can help in withstanding future shocks. Another question is the situation for non bank financial institutions (NBFIs) and funds. Massive downgrades could trigger a new liquidity shock alongside the solvency one.

2.2 The Covid-19 crisis should lead to a sharp increase in loan default rates and NPL stocks across Europe

A regulator outlined how market participants are being confronted with large increases in the debt position of corporates and sovereigns. The banks' number one concern is that this increase, joined with a slow recovery after an aggressive shock, is likely be transformed into an increase of non performing loans (NPLs). This is problematic because they will further impair balance sheets, depress credit growth and delay recovery. The size of the hit on the sector depends on the effectiveness of public policy measures. The guarantee schemes initiated by a number of countries supposedly provide a backstop for the large numbers of NPLs in certain sectors but, nevertheless, some of these changes will spill over into the banking sector.

The vulnerability assessment conducted early in the spring suggested that the banks were well enough capitalised to stop the pandemic and confront a large downturn in the system.

The size of that downturn is still to be determined, so it will need careful monitoring and discussion. That assessment will need to make sure that each institution is working properly, as the pandemic accelerated a number of trends that were already underlying the financial industry, particularly the banking sector, before the crisis began. Another regulator advised that regulators and authorities now need to be careful to distinguish between companies with a decent business model that warrants support and celebrating the past by keeping things going for incumbents. 'Zombification' is still something to worry about, as it reflects a postponement of insolvency procedures and a prolongation of unnecessary support.

2.3 The structurally low profitability of the euro area banking sector remains a concern for financial stability

A regulator reviewed how profitability had been a challenge for some EU banks, even before the COVID crisis, as they faced intense competition and overcapacities in some markets, coupled with sticky operating costs. Another regulator also commented on this severe profitability pressure. Asset quality deterioration would create an additional burden for institutions that are still recovering from the financial crisis. If the situation were to worsen, the depletion of bank capital would be material.

An industry representative agreed about on the low profitability of many European banks, but an analysis has to be made of which branches and companies are viable. Many with minor problems right now will easily survive, if the economy comes back running. In such a context, participants are urged not to implement the so called Basel IV rules or place themselves under extra capital requirements right now. A proper impact assessment at the end of the crisis must be made when deciding which regulations actually work, before creating more.

Another industry representative agreed that, in the near term, managing credit risk will be a major topic for every player. Beyond that, the crisis will act as a catalyst of margin compression in the industry, increasing pressures on capital requirements. Every major player is focused on costs, but there are limits. Sooner or later, businesses will think more about scale and thus consolidation. For larger players, cross border consolidation is really the only option. A dialogue is needed on whether there is political and thus regulatory support for this to encourage financial stability going forward. The Capital Markets Union (CMU) is another approach to strengthening the stability of the system thus supporting the real economy.

2.4 The technological transformation of the banking industry is also challenging

Another trend that has clearly accelerated as a result of COVID is technological transformation. Going forward, the key policy tool is stress tests. These stopped abruptly when the crisis arrived, but they should be relaunched in January next year. A regulator is actively engaging with the ESRB to make sure the scenarios are appropriate. This will be another opportunity to better assess the evolution of the crisis and how the banking sector is dealing with it.

2.5 The stress in a number of core markets in March 2020 laid bare the vulnerabilities of market based financial intermediation

A regulator summarised much of the above remarks as the re emergence of the three big Cs in the years ahead: credit risk, cost management and consolidation. Panellists were asked for their views on any other vulnerabilities. The central bank official stressed that the impact of COVID 19 on financial markets brought the growth of NBFIs and their role in financing the economy under the spotlight. As tools for liquidity management, NBFIs have shown their usefulness, but also their limits, in a stressed context where shocks are likely to be amplified. A clear illustration of this is provided by what happened to money market funds in March, with significant outflows and an impact on short term funding segments.

The forceful central bank actions taken at the height of the crisis were essential for stabilising markets, but they should not be the new normal for central banks to step in when there are shocks. Without prejudging the outcome of the post mortem underway, the central bank official believes in the need to contemplate revisions to the regulatory framework that governs the valuation of funds and the calibration of liquidity buffers, and to complete the toolkit with a suitable macroprudential framework. Less pro-cyclicality is needed in funds' behaviour and liquidity risk management will achieve a stronger and deeper CMU.

A regulator agreed about the importance of understanding what happened during this crisis and not prejudging it. There is no easy answer because there are differences between how currencies and markets operate. The bank and non bank markets are also highly interconnected, so they need to be looked at as a whole. It could be that regulatory changes made in the light of the last crisis will move risk elsewhere, so caution must be exercised in attempting to reduce risks in one sector, as to not simply transfer it to another part of the system. It is also necessary to ensure that any changes to regulatory frameworks in response to the pandemic do not undermine the markets' ability to perform their essential functions – to allocate capital and manage risks. There must also be recognition that the non bank sector will be critical in enabling recapitalisation to promote growth.

Another regulator appreciated the advice about NBFIs. They repeated the mantra: same business, same risk, same rules. A further regulator did not feel that the famous headline 'shadow banking' has been helpful, as it disguises huge differences in business models across the non bank field. A regulator considered the picture more nuanced. What was shadow banking yesterday has suddenly become market based sustainable finance today.

A regulator summarised the principal vulnerabilities that have emerged as pro-cyclicality and non bank financial markets. Avoiding pro cyclicality usually means scaling down certain rules, but the usability of buffers is a double edged sword: there are ways to make them more flexible, but supervisors keep stressing the cost of making certain things more flexible.

Another regulator stressed the need for CMU now, because rebuilding needs equity. Every crisis is also a chance, and three to six months of working in unique circumstances might trigger faster rethinking about two of the Cs, cost management and consolidation. An industry representative added a fourth C to the list, cybercrime, particularly during a crisis like this, when everybody has been working from home. That is likely to hit some sectors worse than others.

3. Opportunities arising from the COVID crisis

In talking of not only risks, but opportunities, a regulator related how the crisis is revealing how banks can really help the economy. In demonstrating their value to society, they are rebuilding reputations that were severely damaged

during the global financial crisis. The crisis is also a good catalyst for the underlying technological transformation of the banking sector.

From a central bank official's perspective, this crisis offers the opportunity to have a dialogue with market participants to further adjust the global framework of the financial system. A case in point is stabilising the non bank financial sector to face shocks. A regulator thinks the responsiveness of the authorities to the crisis was a great thing but, specifically for non bank finance, this crisis is not over. There is a need to consider any responses carefully to guard against any unintended consequences that may stifle recovery.

One industry representative hoped banks will be able to play a crucial role in transforming the planet into a more sustainable place. Another industry representative stated that the level of cooperation between all players, whether supervisors, regulators, policy makers or central bankers, is unprecedented and must be built on, as they work together for more stability in the system. ■