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Videoconference

Jose Manuel Campa's keynote speech at the Latin American Banking Federation

Check Against Delivery
Seul le texte prononcé fait foi
Es gilt das gesprochene Wort

Introduction

At this stage, I don't need to describe the challenges that the COVID-19 pandemic has posed for all of us. Just allow me to provide an example from the institution I chair. In March 2020, we were forced to close our premises in Paris and provide teleworking arrangements for all our staff. It is only now - one and a half years later - we can gradually return to our offices.

If we had been suggested in late 2019 to become a remote organisation – even only for a few days -, I am convinced that we would have had rejected the idea. We would have argued that we were unprepared for such an exercise and that we lacked the operational capabilities to do so. I am also pretty sure that had regulators and supervisors asked banks to do a similar exercise, the response would have been similar. Indeed, we would have probably made the assessment that banks were not prepared.

After all, analysts had been continuously pointing at the slow operational transformation of banks as one of the explanatory factors of the structural low profitability of the EU banking sector. The poor suitability of physical branches to address the needs of an increasing digital customer base along with a sluggish digital transformation – especially in comparison to successful FinTech firms - did not leave too much room for optimism.

I am happy to say that the system proved more resilient that expected. Of course, this does not mean that the process was seamless. But thanks to the commitment of all parties involved business continuity was maintained.

The COVID-19 pandemic was the first real test of the micro and macroprudential regulation set in place after the global financial crisis. This time, with the support of substantial fiscal and monetary measures, in addition to some regulatory measures, banks allowed firms to make extensive use of their credit lines and offered forbearance options for strained borrowers. The full set of these measures allowed the financial sector to dampen the immediate effect of the crisis on economic agents.

Part 1: Regulatory and supervisory responses to the COVID-19 pandemic

The EBA did its bit to provide operational relief to banks and to allow them to shift resources where mostly needed. These decisions were not made lightly.

Postponement of stress test, reporting and consultation activities

Postponing the ongoing 2020 EBA EU-wide stress test exercise by one year, delaying remittance dates for supervisory reporting and putting on hold consultation processes implied a loss of timely valuable information on the banks' latest conditions at the very moment authorities needed it the most. Nevertheless, it was the right thing to do in exceptional circumstances.

The EBA also recognised the need for a pragmatic approach in the 2020 Supervisory Review and Evaluation Process (SREP) as well as for recovery planning. Rather than insisting on business as usual we recommended that supervisory authorities focus their efforts on the most material risks and vulnerabilities driven by the crisis.

Moratoria and public guarantees helped borrowers avoid liquidity challenges

Apart from concerns about business continuity, one of our primary concerns was the risk of a credit crunch caused by the uncertainty created by the pandemic. As many businesses and households were facing liquidity shortages it was important that banks were able to serve the economy and their customers. Avoiding a collapse of credit to the real economy was key.

Public guarantee schemes (PGS) and central banks' extraordinary liquidity facilities supported the flow of lending to the real economy while moratoria provided borrowers with the necessary breathing space.

There was a pressing need to address the prudential treatment of the different legislative and non-legislative payment moratoria introduced in each country. That is why the EBA issued guidelines on payment moratoria on the 2nd of April 2020 clarifying that the payment moratoria would not automatically trigger forbearance classification and the assessment of distressed restructuring if they were based on the applicable national law or on an industry-wide initiative agreed and applied broadly by relevant credit institutions. These guidelines were necessary for avoiding the automatic reclassification in forborne or defaulted status of loans under moratoria. They also confirmed the necessity of a timely and accurate measurement of credit risk.

This helped safeguard borrowers with temporary liquidity problems while at the same requiring the assessment of the long-term unlikeliness to pay.

Looking back, payment moratoria have been an effective tool to address short-term liquidity shortages caused by the limited or suspended operations of many businesses. At its peak in June 2020, there were more than EUR 800bn of loans under EBA-compliant moratoria. As economic conditions have improved this amount has declined steadily. In June 2021 it stood at just EUR 125bn.

Capital and liquidity

Supervisors and regulators also acted to provide relief to banks and ensure the continuation of the flow of lending to the economy. In Europe, the EBA reminded that capital – and liquidity – buffers accumulated by banks over time were a reserve to absorb losses but also to ensure continued lending to the economy. In the same spirit, several macroprudential authorities released the countercyclical buffers and supervisors allowed banks to operate below their Pillar 2 Guidance (P2G).

With the Capital Requirements Regulation (CRR) 'quick fix', the transitional arrangements for smoothing the impact on capital of the introduction of International Financial Reporting Standard (IFRS) 9 on own funds were extended by 2 years. Other measures already in the pipeline were introduced ahead of schedule, such as a revised and more generous supporting factor for lending to small and medium enterprises (SMEs) or the possibility for banks to meet part of their Pillar 2 requirements with instruments other than CET1. In addition, the EBA along with the ECB and the ESRB issued a recommendation to banks to follow prudent dividend distribution policies. All these measures resulted in the free up of capital equivalent to roughly 2% of RWAs.

Banks entered the pandemic with robust capital and liquidity levels

Although all these measures certainly played a very important role for banks to maintain the flow of lending to the real economy, this would not have been possible if banks had not entered the COVID-19 pandemic with robust capital and liquidity levels. Their average common equity tier 1 (CET1) ratio as of December 2019 stood at nearly 15%, well above the 9% ratio observed before the global financial crisis. In fact, the management buffer above overall capital requirements and Pillar 2 Guidance (P2G) was about 3% of risk weighted assets (RWAs). In addition, prior to the pandemic, banks' liquidity coverage ratios (LCR) were on average close to 150%, significantly above the regulatory minimum.

Part 2: Risk and vulnerabilities two years after the pandemic outbreak

Almost two years after the COVID-19 outbreak, EU banks seem to be coping well with it. Banks have been able to preserve these ample levels of capital and liquidity throughout the pandemic while providing lending and restructuring capabilities to their customers.

Capital and liquidity ratios have improved further. The CET1 ratio now stands at 15.6%, while the LCR is above 170%. The NPL ratio has maintained its decreasing trend, albeit at a slower pace, and currently stands at 2.3%. More importantly, the recently published results of the 2021 EU-wide stress test show that, overall, banks will be able to withstand a severe economic scenario characterised by the prolongation of the pandemic in a "lower for longer" interest rate environment. The results show that after an assumed 3.6% cumulative drop in EU GDP over a three-year horizon (which is added to the 6% GDP drop registered in 2020), banks' fully loaded CET1 ratio would fall 485bps to 10.2% on average. Moreover, 90% of the banks in the sample would maintain an excess capital over the total SREP capital requirement of at least 219bps.

The pandemic has accelerated their technological transformation, with more client operations moving to the internet and wide application of teleworking arrangements. This is vital for banks' competitiveness and allows employees and clients to benefit from the use of digital solutions in terms of cost, accessibility and convenience. However, it also increases technology-related risks. Hardware, software or telecommunication malfunctioning might cause significant disruptions in banks' operations. Cyber-attacks have become more frequent and aggressive. The ransomware episodes - mainly observed in other economic sectors for the moment - could similarly affect banks. Notwithstanding the benefits of digitalisation for consumers, it is also fair to acknowledge that banks' clients are now more exposed to phishing attempts and that less digital-savvy customers run the risk of being left behind.

The sound situation of banks is also due, to a great extent, to an improving macroeconomic outlook. The progress in the rollout of COVID-19 vaccines has reduced the pressure of the successive waves of infections on health services, allowing public authorities to relax containment and social distancing measures. Nevertheless, there are still some reasons for concern. Rising infection cases amongst the vaccinated population have casted some doubts about the length of the vaccination effectiveness.

More importantly, vaccination rates in developing countries are still very low, which poses a still big risk. On the one hand, these countries are the perfect breeding ground for the emergence of new COVID variants which may render the current vaccines useless. On the other, existing variants of the virus still wreak havoc in these countries and force authorities to apply severe lockdown measures to prevent the collapse of their health systems. Since many of those low-rate vaccination countries are important providers of raw and intermediate materials to global supply chains, lockdowns in these economies may affect the whole world economy. For instance, the shortage of semiconductors is already affecting some important industries in Western economies such as car manufacturing. In this context, the capacity of expansionary fiscal policies to stimulate growth and employment might be curtailed and inflationary pressures are emerging.

In relation to the latter, the main central banks have reassured financial markets acknowledging they will tolerate temporary periods of inflation above their official targets. Nevertheless, if inflationary pressures are of a more permanent nature than expected, central banks will need to raise rates earlier than the market expects. In such scenario, debt and equity markets might suffer abrupt corrections. Firms that have heavily borrowed during the pandemic or whose revenues have not recovered fully might struggle to meet their financial commitments. If the increase in rates results in a currency appreciation of the USD or the EUR, some emerging economies might also struggle. Earlier this year, the depreciation of the Turkish lira provided an example of the existing vulnerabilities.

It is also noteworthy that, in contrast to previous crises, the COVID-19 pandemic has so far resulted in a decrease in corporate bankruptcies. Tax breaks, furlough schemes, moratoria and PGS, and, above all, the temporary suspension of insolvency regimes, resulted in bankruptcy declarations in the EU to decrease by around 35% in the first two quarters of 2020 and, although they have thereafter rebounded, they are still below the 5-year average. Hence, as support measures expire, asset quality might suffer.

Indeed, rising volumes of NPLs are already observed in some of the sectors most affected by the pandemic, such as hospitality related industries. Even though the cost of risk has returned to pre-pandemic levels the overall share of loans classified under IFRS 9 Stage 2 remains 2pp above its pre-pandemic level.

The share of Stage 2 loans is particularly high among those loans that are still under moratoria as well as for those that have already exited it (ca. 25%). In addition, the NPL ratios for moratoria loans stand well above the average (around 4.5% vs 2.3%). A similar deterioration is observable in PGS loans. Around 18% of them are classified under Stage 2, and their NPL ratio, albeit below the average (2%), has been increasing continuously.

Vulnerabilities are also simmering in traditionally safer loan portfolios. The low level of interest rates combined with pent-up household savings and abundant liquidity is also driving up housing prices at a very fast pace in many EU countries. In case of an abrupt price correction, those banks more exposed to mortgage loans might experience a decrease in the value of their collateral.

In addition to asset quality concerns, it is important to note that before the pandemic, EU banks already had a problem of structural low profitability. Their average return on equity (RoE) had been below their cost of equity (CoE) which is estimated to range between 8% and 10%. During the pandemic the increase in impairment costs drove this ratio to a minimum of 0.5% in June 2020. As impairment costs receded and normalised, RoE levels recovered to ca. 7.5% in June 2021, however still below the estimated CoE.

Sufficient levels of operating income are the first line of defence against negative surprises (e.g. credit risk related losses). Banks with low profitability might be in a weaker position to withstand a stress period. Moreover, banks with poor profitability prospects are usually trading at price-to-book ratios below 1, meaning that, should a capital increase be necessary, this might result in a substantial dilution for existing shareholders.

In a relatively large number of small institutions, high costs as well as insufficient diversification of income sources are some of the drivers of the underperformance of EU banks. These factors also interact with a prolonged low interest rate environment that, while beneficial for the improvements in asset quality and the build-up of MREL buffers, has depressed net interest income, the main source of banks' revenues.

On the cost side, banks were rather slow at reducing their operating expenses before the pandemic as they were – and still are - involved in complex digitalisation and restructuring processes. Although these restructuring processes eventually result in more efficient business structures, their benefits can only be reaped in the medium or long term while their costs are visible almost immediately. The pandemic has accelerated digital transformation and reduced significantly operating expenses as business travels were put to a halt and workers and customers made less use of physical facilities among other factors. Nonetheless, it remains to be seen if these costs will bounce back once all the restrictions to physical movements and social distancing are lifted.

Part 3: Future policy response

Overall, one can say that legislators, regulators, and supervisors have tried to strike a balance between providing flexibility to stimulate lending and maintaining reliable metrics in line with the single rulebook, even during these times of extreme stress. The latter was necessary to maintain an accurate picture on risks evolving in banks and the banking sector more broadly.

As economic restrictions are lifted and many businesses reopen, banks need to differentiate between the viable and non-viable companies going forward. Some businesses have suffered more than others either due to the direct shock to their business model or because they lack the swift ability to develop new initiatives targeted to the changing economy. Some others may have no future because of structural changes, such as a reorientation towards sustainable businesses or towards more digital initiatives.

Banks need to be proactive in identifying struggling borrowers and non-performing exposures, and in addressing these challenges appropriately. The single rulebook, with harmonised definitions of default and forbearance, should ensure that banks set aside higher amounts of capital for the riskier obligors. Banks can then still lend to these risky obligors but have to set aside a sufficient buffer in case financial difficulties emerge. On the other hand, viable households and companies should have sufficient access to finance, such that their lending can foster economic activity. In any case, borrowers experiencing financial difficulties and banks should proactively work together in finding the most appropriate solutions for their circumstances. Some firms will find themselves overleveraged and more equity type financing could be more appropriate for them. In these cases, banks' role of acting as an intermediary will remain important. The completion of the capital markets union agenda could also contribute to ensure a strong and robust recovery.

Regulators and public authorities need to support banks' efforts in managing loan restructuring (forbearance) as well as potential inflows of non-performing loans post COVID-19. At the EBA, we are collectively working with other authorities under the comprehensive Commission action plan from December last year, where the EBA is playing an important role in improving data standardisation to facilitate sales of NPLs and the functioning of the secondary markets for NPLs, looking at the regulatory treatment of sold defaulted assets, as well as contributing to building framework for more effective and efficient securitisation of NPLs – all to help banks better prepare to a potential NPL increase in the aftermath of the pandemic.

A reduction in uncertainty cannot be achieved by relaxing the measurement of risk and its associated requirements. Enforcing the existing rules on provisioning and on capital requirements is needed – both from regulators, but also for investors - to have a true picture of the risks the banks are facing. As such, the focus should remain on allowing a proper recognition of the consequences of the pandemic on banks' lending books and manage the transition to its full exit. This, together with a strong monitoring of banks' asset quality, will ensure that regulators and supervisors have the best view on potential credit deterioration.

The COVID-19 crisis has also proven that the regulatory reforms agreed at the global level in the aftermath of the GFC have been successful in strengthening banks' resilience. Even though the long-term impact of COVID-19 is still to be determined, high capital, ample liquidity, improved asset quality and stronger risk management helped banks to respond to the emergency. This confirms the importance of the Basel III finalisation.

The Basel III framework increases the risk sensitivity of the standardised approaches and limits the ability to model in areas where variability has been known to exist, that is, for those models, where few loss observations exist, which makes the use of IRB estimation methods less reliable. Keeping our goal to preserve a global level playing field and to avoid regulatory fragmentation should be a key principle as we approach the final implementation of the reform.

Those banks that are unable to attain sustainable profitability levels after the return to normality should reconsider their business strategy. Consolidation could play a role in this process. Through mergers and acquisitions (M&A), banks might be able to eliminate redundancies in operating expenses and to exploit existing economies of scale and synergies, for instance through investments in digitalisation. Consolidation might also take place through restructuring or liquidation of those banks unable to modernise their operating structure. However, if such exits of non-sustainable banks do not take place in an orderly fashion, they might pose a risk for the entire financial sector.

After the global financial crisis, weaker banks exited the market at a slower pace in the EU than in other jurisdictions such as the US. This has delayed or prevented the restructuring of banks. In addition, the lack of harmonised liquidation rules and insolvency regimes make the resolution of banks complex and politically sensitive and often results in delayed decision-making.

Before concluding, I would not want to finish without also calling your attention on two salient risks for which we need to enhance our modelling toolkit. The recent anti-money laundering (AML) challenges in a number of jurisdictions brings to our attention that the legal, economic, and reputational consequences of insufficient and ineffective controls in place on AML can last for several years and might affect not only the involved institutions but the entirety of the banking sector. The European Commission has launched an ambitious legislative proposal earlier this year to strengthen the AML regulatory and supervisory framework in the EU. This is a major step forward. But in the interim, we should continue to enhance the existing framework to tackle this risk. Last month, the EBA launched a public consultation on new guidelines on the role, tasks and responsibilities of AML/CFT compliance officers. The guidelines require these officers to have a sufficient level of seniority, which entails the powers to propose, on their own initiative, all necessary or appropriate measures to ensure the compliance and effectiveness of the internal AML/CFT measures to the management body.

Similarly, inadequately addressed environmental, social or governance (ESG) factors might have detrimental consequences on banks and financial stability. All institutions need to continue to enhance their governance, risk management and toolkits to better identify, measure and address these risks. The EBA published in June its Report on ESG risk management and supervision where it provided a comprehensive proposal on how ESG factors and ESG risks should be included in the regulatory and supervisory framework. The report outlined the impact that ESG factors, especially climate change, can have on institutions' counterparties or invested assets. It also compiled available indicators and metrics for an effective ESG risk management and identified remaining gaps. Steps needs to be taken by all stakeholders to advance in this agenda.

Many thanks for your attention