Post-pandemic bank regulation in Europe: Q&A on five investor concerns

“A boat is always safest in the harbour, but it is not what it was built for”
Earl Wilson

Market concerns have resurfaced during the coronavirus crisis regarding the approach by regulators to dealing with a European banking sector facing weaker revenues and rising asset-quality problems. In recent weeks, The Wide Angle has addressed some of these concerns. This Q&A comments on key regulatory-related topics emerging from recent interactions with investors in European bank debt.

With hindsight, is the new regulatory architecture set up after the last financial crisis too punitive for Europe’s banks?

New regulations, while supposedly focusing on the future, are invariably more anchored in the past and present. That being said the regulatory frameworks now in place for European banks have managed to address and try to mitigate the main risks that were evident during the last crisis. They are definitely not too punitive. During the global financial and euro sovereign crises, many observers – politicians, academics, investors, consultants, analysts – and some regulators too, were calling for substantially more conservative capital and liquidity requirements. After years of debating and testing, the resulting new framework turned out to be a good working compromise. And most banks, after the expected initial pushbacks and panic warnings, ended up adjusting to it.

But the main thrust of the post-crisis regulatory effort has been on prudential steps, to make sure that banks have adequate liquidity and capital. And the result was that on balance the European banking sector entered the pandemic crisis in significantly better prudential shape. ECB data shows that in aggregate euro area (EA) banks’ Tier 1 capital rose from 8.8% in 2008 to 15.5% in 2019.

However, new important risks have been arising in the last decade, like misconduct (incl. money laundering), cyber risk, ESG risks. Bank regulations are far less clear and transparent on these new risks than they are on prudential risks. In the EA, supervision of these risks is not carried out as effectively through the Single Supervisory Mechanism (SSM) as prudential risks are. There is substantially more work to be done on the regulatory front, mostly for non-prudential risks.

Is it likely that the regulatory framework will be readjusted but this time in the opposite direction, instituting looser standards?

It is extremely unlikely this is in the cards anywhere in Europe. There is no appetite among regulators or the politicians supporting them to re-open the prudential regulatory reform books. Again, forthcoming regulatory steps will be – or at least should be – towards addressing non-prudential risks such as money laundering.

Is the current prudential supervisory leeway likely to last?

It is. Within the existing regulatory framework, which is very unlikely to be adjusted again, supervisors have announced a softer approach. Specifically, they have been encouraging banks to draw on liquidity and capital buffers if needed without worrying that by doing so they will breach supervisory standards. In addition, the implementation of tougher loan-loss provisioning rules (IFRS 9) is being slowed down, as is the process of NPL recognition.

But the supervisory leeway has one purpose and one purpose only: to encourage banks to continue lending to the economies of the countries they operate in. There is no other area of risk-taking activity which would justify it, and banks going down a different risk path could find themselves in a tougher spot with supervisors. European supervisors realise that an overly strict implementation of prudential rules will keep the boats in the harbour, rather than have them sail as they should.

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So, paradoxically, supervisory leeway should make sure that during the post-pandemic years European banks stay on target and avoid engaging in activities that would not support the economic rebuild. This underpins the view that the current supervisory leeway will remain in place for as long as the banking sector remains committed to supporting economic growth in Europe. Which in fact could be for quite a few years, especially as loan demand is very likely to intensify in the post-pandemic period.

With the tough test of the pandemic, is the Banking Union a real positive for bank supervision or just a token one?

There are some who say that, as the pandemic has led to the closing of national borders and governments focusing mostly on their own people, the supervision of banks in the EA should also re-balance back to national authorities. But the Banking Union, and especially the successful implementation of its first pillar, the SSM, has been one unmitigated success story of EU integration so far (perhaps, second only to the adoption of the euro). The fact that, on balance, EA banks display much-improved prudential metrics is in no small measure thanks to the new and more effective supervisory system led by the ECB. This is night and day compared to the sub-par box-ticking supervisory cultures in too many countries in Europe at the onset of the last financial crisis.

However, « le mieux est l'ennemi du bien » (*perfect is the enemy of good*), as Voltaire wrote 250 years ago. While the first pillar of the Banking Union – the SSM – has been a real success so far, and the second pillar has created a credible framework for resolution planning, pushing too hard too fast for the implementation of the less convincing third pillar – the European Deposit Insurance Scheme (EDIS) – could run into political and cultural headwinds and may end up being self-defeating. Also, the ECB calling too insistently for pan-EA consolidation among large banks does not seem to be convincing. In the growing digital age, the economics of large cross-border M&As are not there, since accessing clients across borders through open platforms and APIs – as opposed to legacy physical structures – will likely carry the day.

Can resolution still fit in the post-pandemic regulatory framework?

A lot of effort has been expended so far in setting up resolution-planning processes by banks and regulatory authorities. Indeed, resolution planning will likely remain a powerful supervisory tool helping banks to clarify their own trajectory in the event of major stresses. It will also continue to help regulators – supervision and resolution authorities alike – to understand, challenge, and if necessary, steer it. Joint supervisory-resolution colleges, if carried out well, can add real value in keeping the scrutiny process alive.

On the other hand, the likelihood of a significant European bank ending up in resolution is more remote than at any time since the last crisis. This is true not only now, in the middle of the pandemic, when regulators will be loath to initiate such a radical step even if a candidate emerged. Rather, it will rather persist well into the post-pandemic years, as banks will be expected to play a central role in the economic rebuild.

In fact, this makes the case for credit investors to readjust their analytical lenses for banks and de-emphasise the threat of resolution as the lodestar of danger. Like war planning, it is much better that bank resolution remains just a planning tool and is not turned into action.

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