WORLD ALLIANCE
of International Financial Centers

Impact of COVID-19 on the Future of Banking Regulation

IMPRINT

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Addressing the COVID-19 impact is a key task of the regulatory agenda

The financial industry welcomes the flexibility shown by authorities and measures taken by international regulatory bodies (e.g., the Financial Stability Board FSB, the Basel Committee on Banking Supervision BCBS, or the International Organization of Securities Commissions IOSCO) and governments and central banks in support of businesses and households amid the COVID-19 pandemic. It has been essential to ensure the smooth functioning of the economy with adequate liquidity to facilitate the flow of funds to businesses and households facing an unprecedented “sudden stop” in economies worldwide.

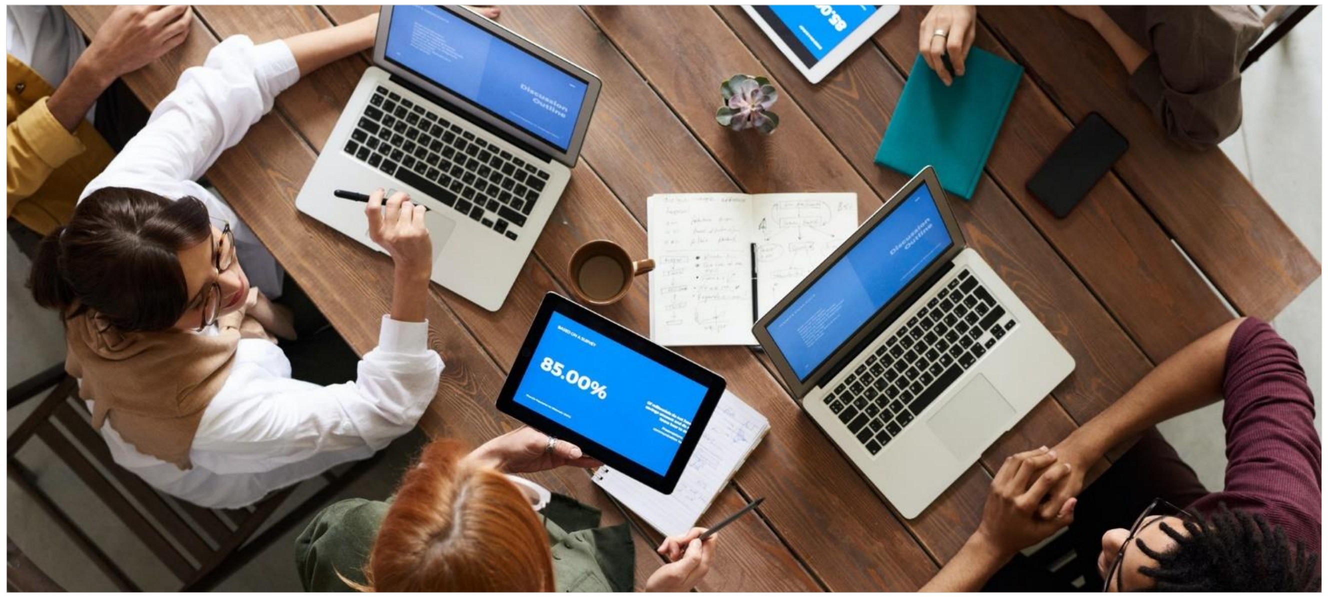
In this health crisis, which forced governments to impose an unprecedented stop to the economy, and only partial/temporary reliefs from lockdowns depending on jurisdictions, the provision of capital and liquidity support to corporates and households by banks and capital market participants, with the help of public bodies, has been vital to minimize the social and economic cost of the pandemic. Starting from a substantial capital and liquidity base, banks and financial institutions at large have been “part of the solution,” and it was essential to avoid transforming the health crisis into a financial crisis.

It is evident, however, that the full consequences of the COVID-19 crisis have not yet manifested themselves, given that the worst immediate effects of the pandemic on the economy have so far been mitigated by the readiness of national governments and financial institutions to deploy a range of tools to sustain the economy.

Financial institutions have played an essential role in supporting the real economy in the current crisis, working closely with governments as they extend lending to households and businesses in an effort to mitigate the adverse effects of COVID-19. Banks provide unprecedented assistance to customers affected by the COVID-19 pandemic, e.g., through moratoria and specific loan programs. This essential support should continue while also acknowledging the further need for additional lending to finance the recovery and foster the transition to a greener and more digital economy.

Banking regulation has to contribute to the economic recovery

The prospects for the industry and the businesses it supports depend fundamentally on the pace of economic recovery. Projections currently estimate that the world economy will recover to 2019 GDP levels in late 2021, as estimated by the <u>International Monetary Fund</u> IMF in its World Economic Outlook Update dated January 2021 (see Appendix). But there is a range of potential scenarios for how the global economy could develop in the coming months and years amid exceptional uncertainty. According to the IMF, the strength of the recovery is projected to vary significantly across countries, depending on access to medical interventions, the effectiveness of policy support, exposure to cross-country spillovers, and structural characteristics entering the crisis.



As the financial industry prepares to support the next phase of economic recovery, it also responds to the regulatory environment in which it operates. One of the principal developments is the upcoming implementation of the final package of post-Global Financial Crisis regulatory reforms for banks, known as "<u>Basel III finalization</u>," a package agreed by the <u>Basel Committee on Banking Supervision</u> (BCBS) in 2017, and initially due to be implemented by 1 January 2022. To provide financial institutions with more flexibility, the Basel Committee decided to postpone the implementation of the final Basel III package from 1/1/2022 to 1/1/2023.

Implementing Basel III strengthens the banking industry's operational resilience and provides a solid bedrock for economies struggling through COVID-19. However, the process requires a considerable transformation in credit risk, market risk, and operating models. At the same time, current regulatory trends require banks to prioritize investments in additional internal technology and risk management capabilities, over dedicating resources to other areas.

The pandemic has already shown large impacts on banks' balance sheets

In this context, as the course of the pandemic and its economic consequences become more apparent over the following months and years, international regulators should carefully monitor the interaction of Basel III implementation with the economic situation. For regulatory reviews to be effective, it will be critical for regulators to understand the impact of implementing Basel III fully. The most recent impact study published by the BCBS dates back to December 2020, but it is based on bank data as of 31/12/2019, i.e., it does not reflect the COVID impact. An updated and more detailed appraisal of the consequences of the COVID-19 crisis on the impact of the package will be essential to inform implementation strategies.

Up-to-date knowledge is essential because COVID-19 has significantly impacted the size and structure of banks' balance sheets. For example, EU banks saw an increase by 10% of their total balance-sheet assets in 1H 20, reflecting in particular:

- **the growth in lending volume**
- **higher volatility in the capital market - increasing the balance-sheet value of market instruments considerably, and**
- **the exceptional liquidity provisions by central banks, resulting in much higher liquidity buffers.**

It seems likely that these impacts will not prove short-lived, as monetary policy is expected to remain ultra-accommodative for some time and as loans granted to customers in the emergency phase are progressively converted into longer-term loans to allow smooth repayment schedules. The quality of credit portfolios will also likely evolve, with some industry sectors being winners or losers in the crisis, creating asymmetries across banks, depending on their business models and geographic footprints. There is a risk that bank capital may be hit by the combination of reduced returns in the low-rate environment and higher credit losses.

New considerations for the BCBS priorities

While such uncertainties remain, it will be necessary for BCBS monitoring studies to provide a revised and updated picture of the true impact of Basel III implementation. Regulators should continue to work with industry to explore the extent to which increased capital requirements may negatively impact the financing of economic activity, including the levels of finance flowing to higher risk destinations versus lower risk destinations. Particular attention should be paid to the consequences for SMEs and consumer finance and the geographical spread of investments to ensure access to finance is spread across society, including emerging markets and vulnerable households.

The BCBS, understanding these dynamics, decided to defer the implementation of the Basel III framework by one year to January 2023. It further opted to phase in one component of the Basel III reforms - the “output floor” - over a 5-year period to address concerns about a cliff-edge effect. Both of these steps are examples of the kind of flexible approach that is helpful in the age of COVID-19. Depending on economic trends, it may be worth exploring phase-ins for other aspects of the reforms (credit, market, operational risk).

While keeping a close eye on how regulatory changes interact with the post-COVID-19 economic environment, it will also be essential to take a long-term view of the impact of prudential regulatory reforms since the Global Financial Crisis (GFC). According to the BCBS Basel III Monitoring report published in December 2020[1], banks have already more than doubled their capital base since the GFC: from end-June 2011 to end-December 2019, the level of Group 1 banks’ CET1 capital has increased by 98.8% from €1,944 billion to €3,865 billion. According to numerous regulators’ speeches, this very high level of capitalization allowed them to absorb the estimated shock linked to the COVID-19 pandemic, a real-life stress test of unprecedented magnitude since World War II. This is an impressive achievement.

The priority now is to balance the need to safeguard this achievement with the mandate given by the G20 to the BCBS to finalize the Basel III accord with “no significant capital increase,” all in a time of economic turbulence and high uncertainty in the pace of the recovery. Finding the right balance will be of utmost importance to the businesses and entrepreneurs working on engineering a recovery. Notwithstanding the critical role of capital markets in many countries, and for many borrowers, particularly SMEs, bank lending remains the primary source of financing. Moreover, for capital markets to function smoothly and be able to absorb market shocks without requiring considerable central bank interventions, banks need to be able to provide sufficient market-making capacity to absorb shocks.

[1] https://www.bis.org/bcbs/publ/d512.htm - see graph in appendix

Some regulatory flexibilities to explore further?

The key priority now is for regulators and the industry to avoid implementing unnecessarily recessive regulations, continuously analyzing the lessons learned from the crisis, and considering targeted regulatory adjustments when needed to support sustainable economic recovery and ensure financial stability.

In particular, the flexibility provided at the onset of the COVID crisis should be revisited to assess whether such measures should be extended, adjusted, or reviewed to ensure that they are effective while preserving prudent risk measurement. The key measures introduced by the BCBS include notably:

- Deferred implementation of Basel III (announced 27 March 2020): the implementation date of the Basel III standards (December 2017) has been deferred by one year to 1 January 2023. The implementation of the revised market risk framework finalized in January 2019 is also postponed by one year to 1 January 2023. Pillar 3 disclosure requirements finalized in December 2018 are deferred by one year to 1 January 2023.

- Expected Credit Loss (ECL) accounting: it was agreed that the industry should use flexibility embedded in ECL frameworks, given the high level of uncertainty surrounding forward-looking risk assessments. There is the possibility for jurisdictions to apply transitional arrangements when implementing ECL, such as a delayed implementation of CECL in the US, and the option to temporarily add back IFRS9 additional provisions to CET1 in the EU- (However, the impact of transitional arrangement on risk-based capital ratios and leverage ratios should be disclosed). This temporary relief should lead regulators to consider to which extent permanent adjustments may be needed to avoid excessive pro-cyclicality in provisioning rules.

- Government support measures: it was clarified that sovereign risk-weight treatment could be applied to government-guaranteed loans. It was also defined that for treatment of loans subject to payment moratoriums, the payment moratorium period can be excluded from the past due count. The ability to repay based on rescheduled payments was allowed. This applies to the capital treatment of loans and NPL classification. The phasing out from such moratoria and public guarantee schemes will need to be implemented with caution to avoid a wave of non-performing exposures that would severely damage a fragile recovery.

- Buffer usability of capital and liquidity buffers: the objectives are to absorb losses and facilitate lending to creditworthy borrowers. The BCBS has emphasized that buffers are there to be used. Many jurisdictions with countercyclical buffers in place have released them, but the industry retains some reluctance to use capital conservation buffer (CCB) flexibility. Many jurisdictions have also placed restrictions on dividends or share buybacks. Progressively restoring a fair remuneration of the risks taken by bank shareholders is essential to preserve banks‘ future access to capital. The effectiveness of the buffer framework should also be revisited, as, apart from the contra-cyclical buffer, other buffers did not work as intended.

Contemplating post-COVID-19 regulatory horizon

Many COVID-related measures are logically expiring or will expire in the coming months (due to their very high budget costs and potential impact on the so-called zombie firms). However, they should not expire too early and not before we have a strong recovery. Premature removal of support measures could exacerbate the fragilities of the economies and prevent banks from providing adequate financing to the economies.

This could be particularly significant for SMEs as banks would be more reluctant to extend or roll-over credit if, for instance, government guarantees or regulatory flexibility are removed or suspended too early. While reversing current policies too soon could be a costly policy mistake, the risk of creating a "zombie economy" is not to be underestimated.

In this regard, the different types of support policies deployed since the beginning of the crisis should be distinguished, and their phase-out should be sequenced according to a careful analysis of their respective costs and benefits, which will continue to evolve as the health and economic crisis unfolds.

With the view of avoiding cliff effects and taking into account that situations differ across jurisdictions, some guiding principles could be defined to harmonize the exit strategies in an interconnected world:

- **Crisis-related fiscal support may need to be exited first as it weighs considerably on public debt, and as the focus should gradually shift to investment (both public and private) to promote sustainable growth**

- **Gradual monetary normalization should be envisaged over the medium term: although extremely valuable to avoid a credit crunch, "lower for longer" rates and an unlimited supply of liquidity creates excessive distortions over the long term, in particular by weighing on banks' profitability, which reduces their capacity to lend, and creating financial asset bubbles, which exacerbate inequalities and does not contribute to sustainable value creation**

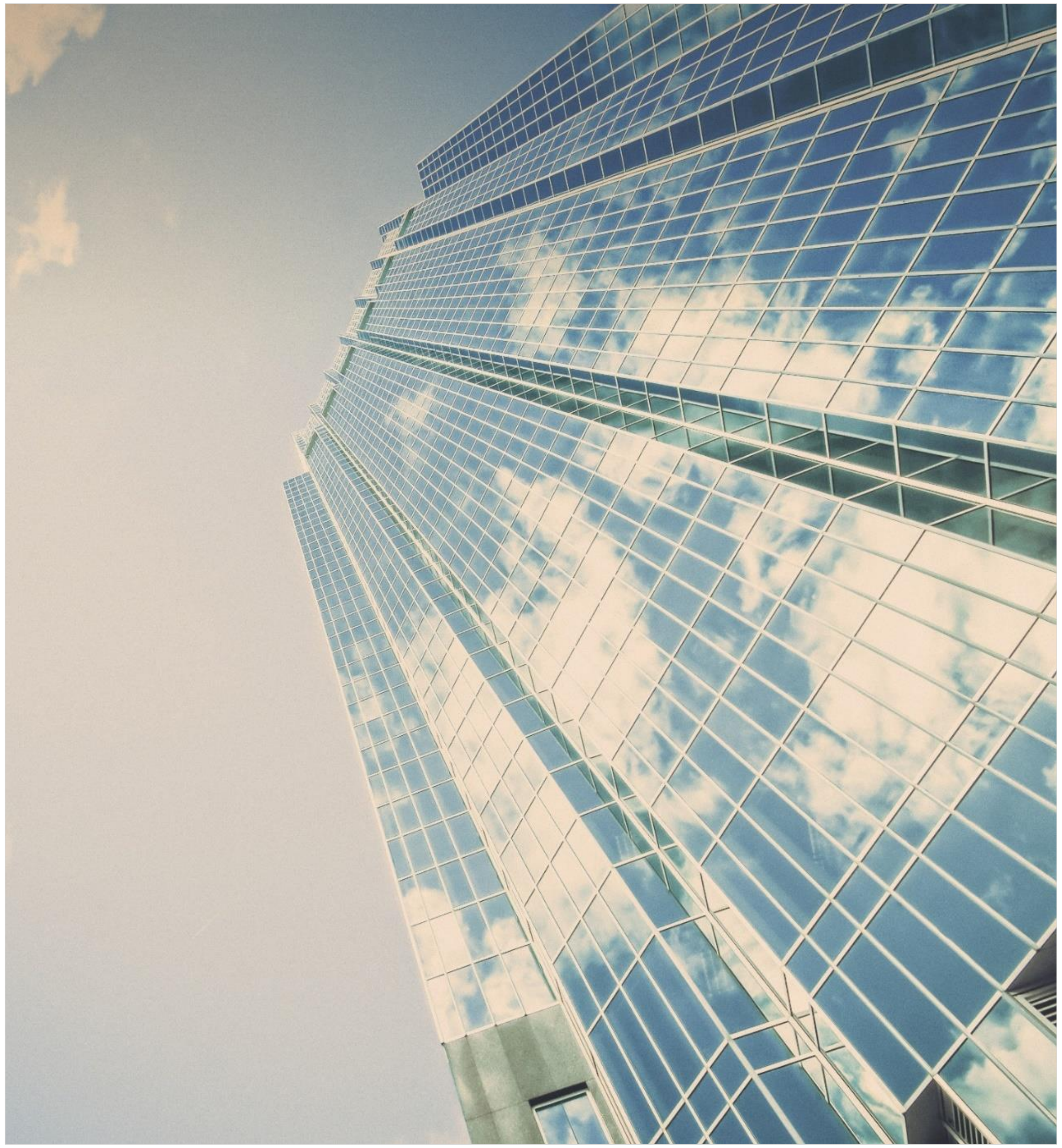
- **Regulatory flexibility should be maintained, and if necessary adjusted, as long as the world economy has not recovered its pre-crisis level. Coordinated measures by the FSB and international standard setters proved highly effective in freeing up capital for banks to serve as a conduit to distribute to companies and households the liquidity needed to face the economic shock generated by the pandemic. In this crisis, banks are part of the solution. Those measures mitigated the pro-cyclicality embedded in the post-crisis framework, at no cost to public finances and without jeopardizing financial stability. Looking forward, as and when public support measures are progressively phased out, banks will need to be ready to act as a bridge toward the "new normal": banks and private sector will need to substitute to those public financings to avoid a cliff effect in crisis responses and growth-oriented investments.**

- **In this context, international standard setters should (i) pivot their agendas towards measures that would support the recovery and a new international agenda including sustainability, and (ii) de-prioritize regulatory tightening measures, which would by definition have a recessive effect. Among other things, this would imply to:**

    - **Ensure that the implementation of the final Basel III agreement does not result in a significant capital increase, particularly in jurisdictions that rely the most on bank funding (such as Europe, Japan, etc.). Indeed, any increase in capital requirements would unnecessarily freeze such capital, which otherwise would be available to finance the recovery.**

    - **Draw the lessons of the crisis on the post-GFC regulatory framework, which is currently experimenting with its first "real-life stress." Targeted adjustments in terms of usability of buffers and excessive pro-cyclicality, better international harmonization in credit risk assessment, notably NPL classification and provisioning rules, should be prioritized and implemented quickly to take effect as early as possible in the crisis exit timeframe.**

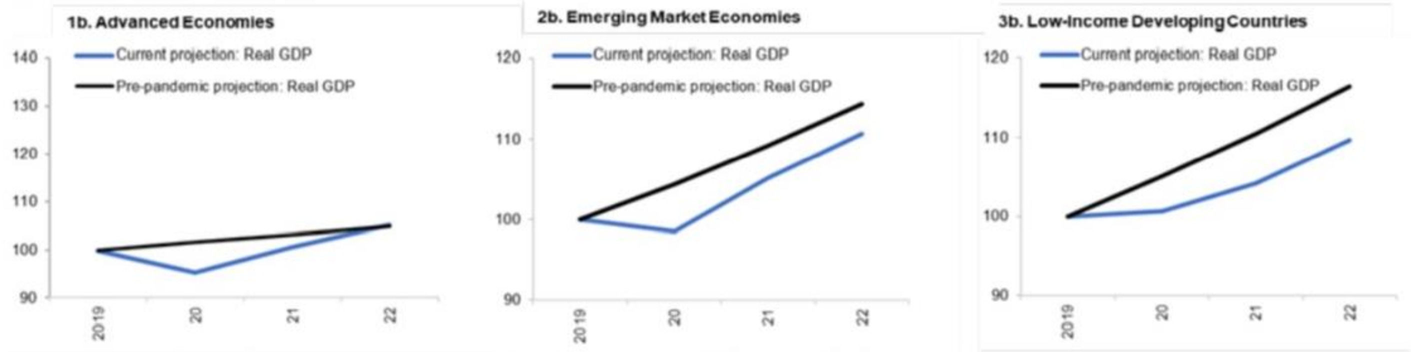
    - **Addressing the new sources of systemic financial risk: as outlined by the FSB in its Holistic Review of the March 2020 Market Turmoil, the crisis has delivered clear lessons on where global financial systemic risk now lies. While banks have entered the crisis with a high level of capital and liquidity, the magnitude of the economic shock has exacerbated existing weaknesses in other parts of the international financial system, bringing to light the fact that systemic risk has been shifting toward the non-bank financial intermediation (NBFI) sector.**



Appendix

IMF WEO UPDATE July 2021

Effect of the COVID-19 Pandemic on Forecast of Real GDP, 2019-22 (Index; 100 = 2019)

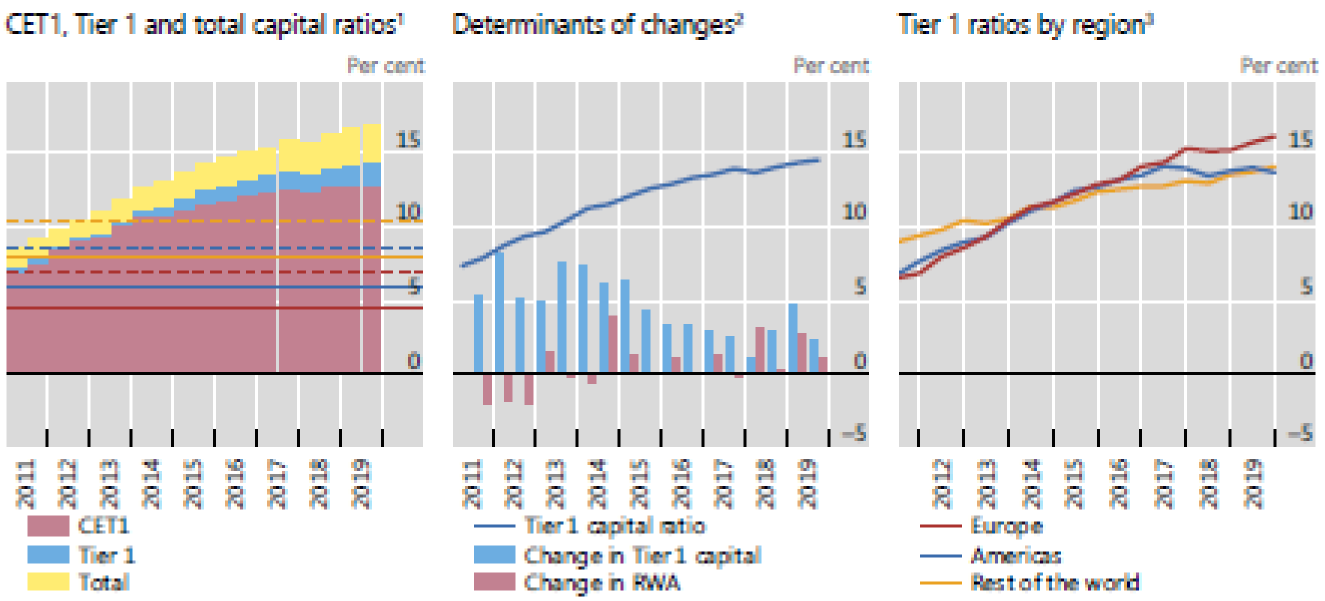


Sources: IMF World Economic Outlook Database and IMF staff estimates
Note: The primary balance is the overall balance, excluding net interest payments. Pre-pandemic projections are from the January 2020 World Economic Outlook.
Link: World economic outlook update, July 2021

BASEL MONITORING REPORT, December 2020

Initial Basel III capital ratios increase slightly

Consistent sample of Group 1 banks — Graph 1



[1] The solid lines depict the relevant minimums, the dotted lines the minimums plus the capital conservation buffer. See Table A.4 for the relevant levels. [2] Exchange rates as of the current reporting date. [3] See Table B.1 for the composition of the regions.

Source: Basel Committee on Banking Supervision. Link: Basel III Monitoring Report (bis.org), December 2020

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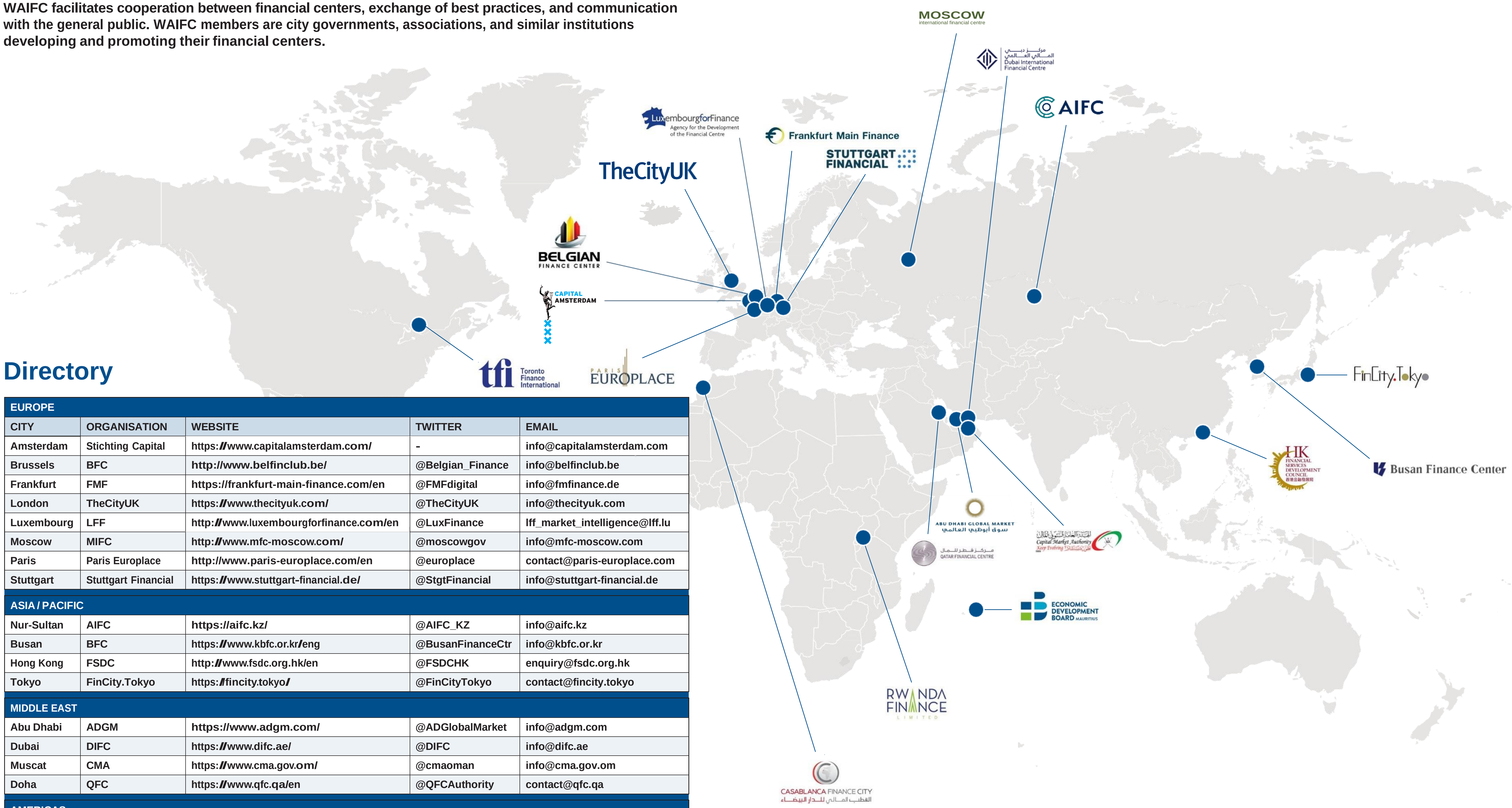
WAIFC facilitates cooperation between financial centers, exchange of best practices, and communication with the general public. WAIFC members are city governments, associations, and similar institutions developing and promoting their financial centers.



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