BANK FOR INTERNATIONAL SETTLEMENTS

The prudential response to the Covid-19 crisis

Speech by Claudio Borio
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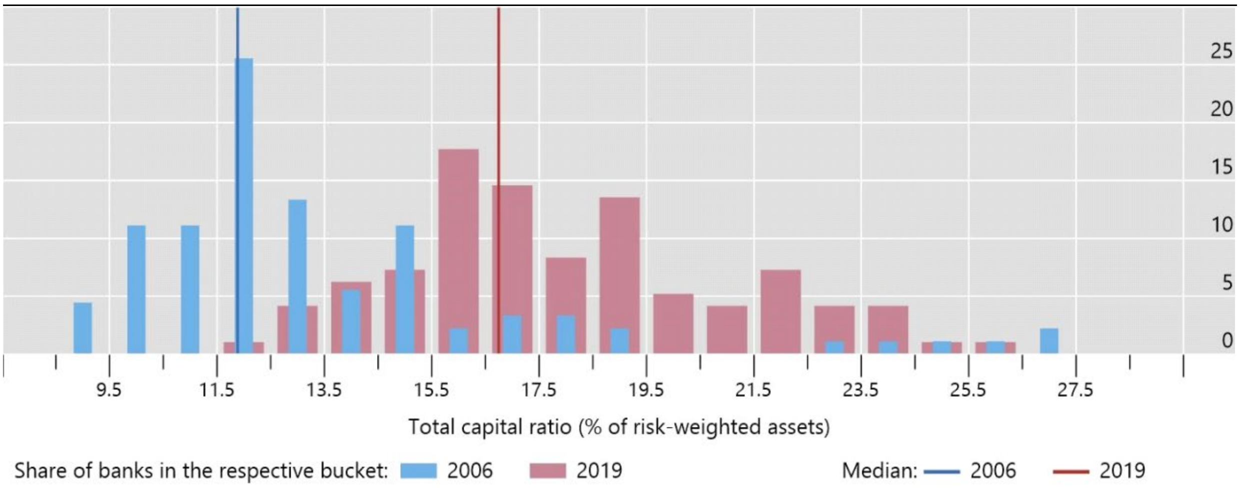
Much has been said about the uniqueness of this crisis – a crisis that results from a policy to tackle a health emergency and to save lives through containment measures. This means that, in contrast to the Great Financial Crisis (GFC), this crisis is truly exogenous, not the result of the unravelling of previous financial imbalances; truly uncertain, in the *specific* sense that the wide range of possibilities depends on unpredictable *non-economic* factors; and truly global – despite how the GFC is generally portrayed, many countries did not actually experience it.

But there is another feature that makes the present crisis rather unique. The shock found banks in a strong financial position, to the point where policymakers have looked upon them as part of the solution rather than as part of the problem. And all this largely thanks to the post-GFC financial reforms, which strengthened banks' balance sheets and may have contributed to their more subdued expansion.

Banks entered the crisis with higher capital…[1]

In per cent

Graph 1



[1] Based on a balanced sample of 135 large banks. The increase in capital ratios is likely to be higher than portrayed due to more stringent rules on regulatory capital and risk-weighted assets introduced after the GFC.

Source: U Lewrick, C Schmieder, J Sobrun and E Takáts, "Releasing bank buffers to cushion the crisis – a quantitative assessment", *BIS Bulletin*, no 11, May 2020.

Graph 1 illustrates the point quite vividly. Based on a sample of 135 large internationally active banks, it shows the percentage of institutions with a given ratio of capital to risk-weighted assets at the end of 2006 and 2019, respectively. We see that the whole distribution has shifted to the right. For instance, the median capital ratio has increased from some 12% to roughly 17%. Moreover, these figures actually underestimate the extent of the improvement, since the quality of capital is higher now.

I said that policymakers were looking upon banks as part of the solution. What does this mean exactly? What are the challenges that lie ahead? And how do they relate to those of monetary and fiscal policies? In exploring these issues, I will highlight another important role that central banks have played in the management of the crisis – the one wearing their regulatory and supervisory hat.

The solution, not the problem

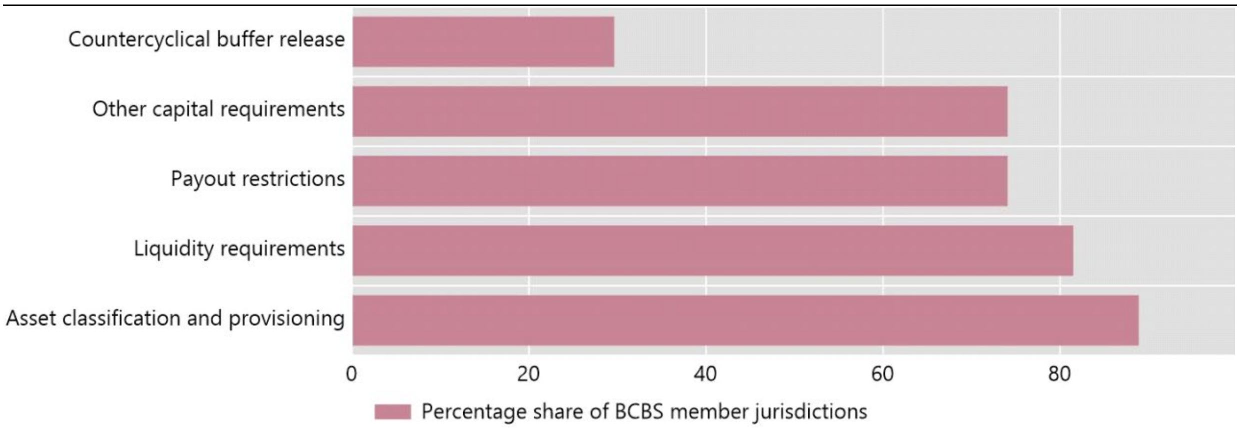
Yet another unique feature of this crisis concerns the prudential response. Supervisors did not tighten the policy stance in order to shore up banks; rather, they encouraged banks to use their accumulated buffers. By "buffer" I mean the amount of capital that exceeds the regulatory minimum. The objective has been to ensure that banks sustain the flow of credit to the economy. Despite the growing role of market-based finance, banks still actually provide the bulk of credit to firms and households around the world.

The response did not just reflect the sense that everyone had to play their part in dealing with the economic emergency. More fundamentally, it reflected a post-GFC change in perspective – a shift from a purely microprudential (MiP) to a macroprudential (MaP) or systemic perspective. We addressed this shift in more detail in the Annual Economic Report two years ago.

A key idea in this *specific* context is the fallacy of composition. It may be rational and indeed compelling for each institution to retrench and cut lending as the outlook deteriorates. But if all institutions do so, they may actually end up worse off because of the spillbacks from the real economy. This is yet another instance of the excessive "procyclicality" of the financial system.

…facilitating the unprecedented prudential response

In per cent | Graph 2



Sources: Basel Committee on Banking Supervision; BIS calculations.

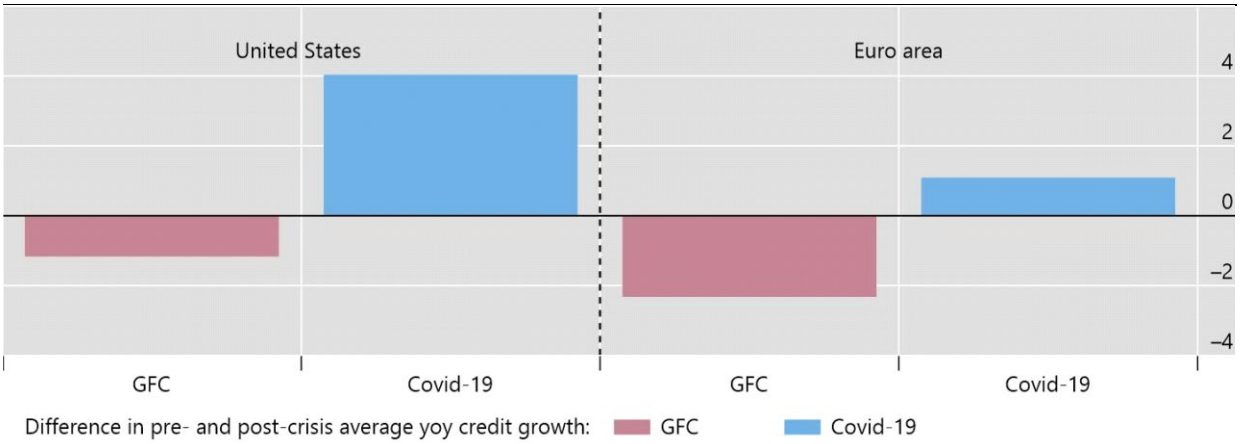
Graph 2 illustrates the wide range of measures taken by prudential authorities in the 27 member countries of the Basel Committee on Banking Supervision (BCBS), largely under its guidance. We can see that, using the available flexibility, many authorities temporarily eased both capital and liquidity requirements; imposed blanket distribution restrictions, such as on dividends; and eased the classification of exposures, such as non-performing loans as well as the regulatory treatment of accounting losses – specifically, the new expected credit loss provisioning standards.

On the whole, the policy has been successful so far, because banks have acted more as shock absorbers than amplifiers. They have not deleveraged and have kept credit flowing. A concrete example is that as firms drew heavily on their credit lines, banks did *not* cut other forms of lending. Graph 3 portrays the change in credit growth around the current crisis and the GFC, in the United States (left-hand side) and in the euro area (right-hand side). We see that in both countries credit growth fell around the GFC, but it actually increased around the current one.

Credit has expanded considerably more during this crisis than it did during the GFC

In percentage points

Graph 3



Pre-GFC = August 2007–August 2008; pre-Covid = January 2019–January 2020; post-GFC = October–December 2008; post-Covid-19 = March–May 2020 for the United States and March–April 2020 for the euro area.

Sources: National data; BIS calculations.

Challenges

The success so far has not been challenge-free. Let me mention some of the challenges already faced and some that lie ahead. I will highlight three:

First challenge. The MaP buffer par excellence – the countercyclical capital buffer – has fallen short of expectations. If we go back to Graph 2, we see that it was the least used measure. Only some 30% of the BCBS member countries released it, and most had simply failed to raise it in the first place. Even where they had raised it, the amounts involved were generally small. In the end, ironically, the burden of adjustment fell on MiP-type measures. In part, the limited build-up of the buffer reflects the wholly exogenous and unexpected nature of the shock. But it is also in part due to political economy pressures not to raise it when things go well.

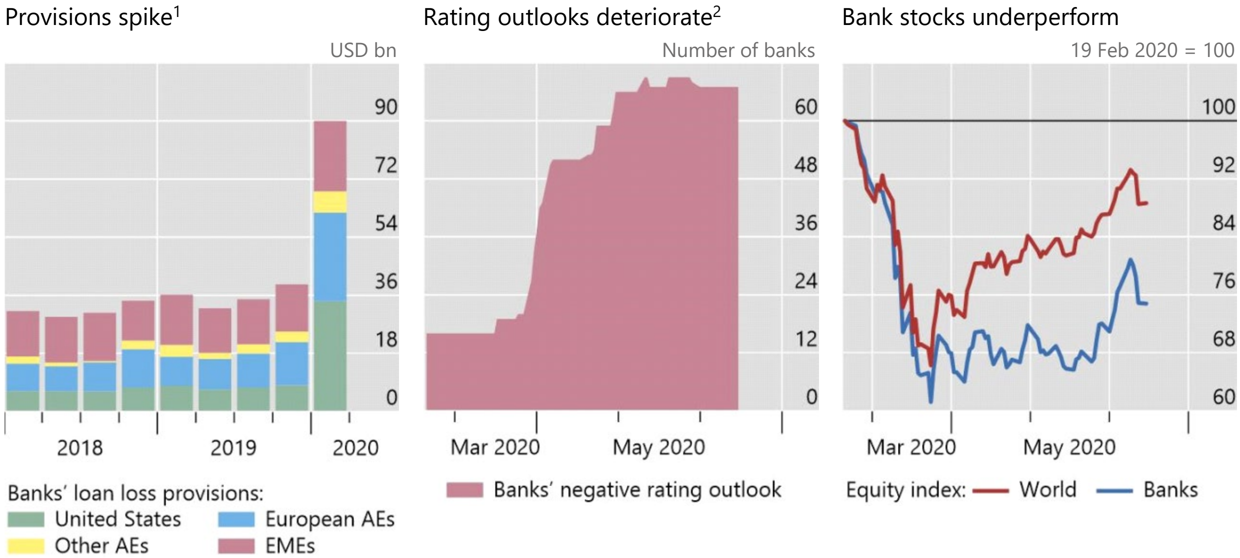
Second challenge. Banks have generally been very reluctant to draw down buffers and, rather than conserving capital, they have preferred to pay out dividends – especially the weaker ones, with unattractive price-to-book ratios. That is why many authorities have taken remedial action.

One measure has been to introduce *blanket* dividend restrictions. Their blanket nature matters because it reduces the incentive to deleverage – banks cannot avoid the restrictions by refraining from lending – and because all banks face them – there is no stigma, as the individual strength of any given bank is irrelevant.

Another, critical measure has been government guarantees on new loans, which have insulated banks from possible losses and de facto socialised those losses. In many cases, these guarantees have gone hand in hand with debt moratoriums, which have supported borrowers, at least for a while.

Third challenge. What if the crisis is deeper and more protracted than expected? As we can see from Graph 4, banks have already started making losses, as reflected in rapidly rising provisions (left-hand panel); rating agencies have started putting them on negative outlook (centre panel); and markets have taken notice, hence the underperformance of banks' equity prices (right-hand panel).

Banks are under pressure… Graph 4



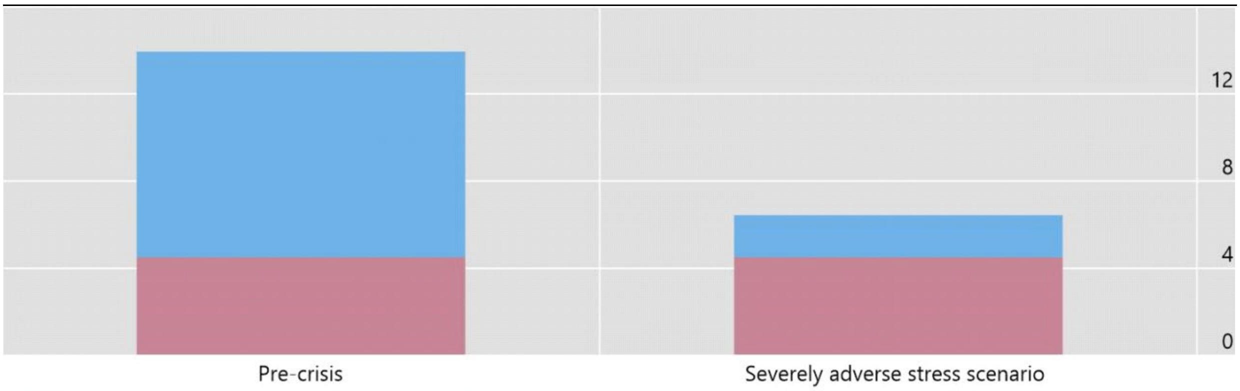
[1] Sum of quarterly loan loss provisions across sample of banks. Due to data unavailability, data for reclassified impairment of loans used for several banks. Due to newly introduced expected loss provisioning standards, a break in the series is expected which could show up in different periods across countries, starting in 2018. [2] Fitch long-term rating outlook for a constant sample of 108 banks. Rating outlooks were fairly stable in the months leading up to March 2020.

Sources: I Aldasoro, I Fender, B Hardy and N Tarashev, "Effects of Covid-19 on the banking sector: the market's assessment", *BIS Bulletin*, no 12, May 2020; Datastream; FitchConnect; SNL.

A simple sensitivity analysis exercise based on 5,600 banks around the globe sheds further light on this issue (Graph 5). On average, capital buffers are sufficient to absorb a shock of a similar size as the GFC: the amount of Common Equity Tier 1 (CET1) capital remains above the regulatory minimum. Moreover, this exercise does not take into account the protection provided by the generous government guarantees.

…and buffers are limited if the crisis persists[1]

In per cent | Graph 5



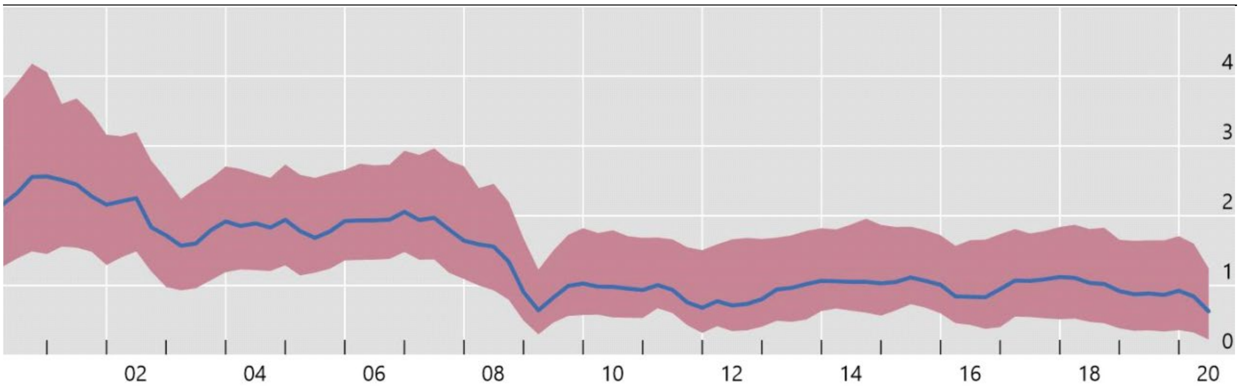
[1] Sensitivity analysis based on a sample of 5,600 banks at end-2019; the stress scenatio replicates the Great Financial Crisis.

Source: U Lewrick, C Schmieder, J Sobrun and E Takáts, "Releasing bank buffers to cushion the crisis – a quantitative assessment", *BIS Bulletin*, no 11, May 2020.

Still, there is no room for complacency. This real-life stress test is generally more severe than those carried out by the authorities pre-crisis, and we do not know how long the crisis will last. Moreover, while banks' capitalisation is strong, their profitability has become structurally low, especially in some jurisdictions. As Graph 6 suggests, the evolution of banks' price-to-book ratios indicates that financial markets see low profitability going forward. This is important because profits are the first line of defence against losses and determine how fast banks can bounce back from a shock. We will probably understand better the true situation once the debt moratoriums expire and the extent of firms' defaults becomes apparent.

Banks' profitability is structurally low

Ratio | Graph 6



[1] Asset-weighted average of selected banks in AU, CA, CH, EA, GB, JP, SE and US.

Sources: Datastream; Datastream Worldscope; BIS calculations.

Final considerations

All this points to a couple of final considerations: one, more specific; the other, more general.

The more specific one concerns the use of banks' capital buffers. Clearly, their extensive use is better suited to deal with borrowers' illiquidity rather than their potential insolvency. The fallacy-of-composition argument is valid, but has limitations: if the size of the *exogenous* shock is large enough, losses could overwhelm banks' defences.

Hence two difficult questions. At what point should supervisors begin asking banks to replenish, rather than deplete, buffers? And if losses do indeed deplete banks' loss-absorbing capacity, what should be the role of the public sector's backstop in socialising them?

The more general consideration concerns the role of policy buffers at large, including those for monetary and fiscal policies. This episode has reminded us once more that precautionary buffers, far from being a luxury, are absolutely essential, regardless of how unlikely adverse outcomes may appear. Once the crisis is over, and as soon as conditions allow, rebuilding buffers should be a priority.

Indeed, rebuilding policy buffers is likely to be *the* challenge of the decade ahead. Monetary policy used up substantial policy space post-GFC. Fiscal policy, even as debt-to-GDP ratios rose to cushion the blow, was rightly invoked to take up the relay in the next downturn. Now, it has fully played its part, even as monetary policy, unfortunately, was unable to take a breather. But, fiscal policy has played such an active role at the cost of risks to sustainability in some countries.

The pre-Covid crisis experience has shown just how difficult it is to normalise monetary policy and to consolidate fiscal positions; only prudential policy succeeded in replenishing buffers post-GFC. Failure to regain room for policy manoeuvre would raise material risks for macroeconomic, price and financial stability. Prudential policy, while essential, cannot alone carry the burden of securing financial stability.

Regaining policy space will require *patience* and a firm focus on the long term. It will also require a clear recognition that neither monetary policy nor fiscal policy can, on their own, generate sustainable growth alongside financial stability. Only a judicious mix of monetary, fiscal and prudential policies, underpinned by badly needed structural reforms, can do so.

Thank you.