

## Prudential policy after the pandemic

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### 1. Introduction

The Covid-19 pandemic's impact has been extreme in many respects. First, the scale of this health crisis is almost unprecedented. Second, the resulting lockdowns and mobility restrictions have created the sharpest fall-off in economic activity and employment in decades. Finally, the worldwide policy response has probably been the boldest and the most synchronised ever.

Regarding policy, the fiscal and monetary authorities have adopted a largely expansionary stance, and some have also used instruments that were rarely employed in the past. No less remarkable has been the response from regulators. Possibly for the first time, they have explicitly assumed a macro-stabilisation role. Indeed, their actions have been openly geared towards maintaining credit flows to firms and households, to soften the pandemic's impact on economic activity and job creation. With a suite of regulatory relief measures, they have adopted a macroprudential approach along the lines drawn up in the post-Great Financial Crisis (GFC) reforms.

In this, the supervisory authorities had to face difficult trade-offs, as the macro and micro dimensions of prudential policies may well clash with each other. Indeed, the pandemic constitutes a relevant real-life test to assess the performance of the post-crisis regulatory reform in situations of banking stress. In particular, it may help to analyse the extent to which the new regulatory framework allows authorities to meet both their microprudential and macroprudential objectives.

In this intervention I would like to review the key challenges for prudential authorities after the pandemic. I will address both supervisory issues and regulatory matters, as the Covid-19 episode has had implications for both domains.

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The views expressed are my own and not necessarily the views of the BIS or Basel-based standard-setting bodies.

## 2. On supervisory challenges

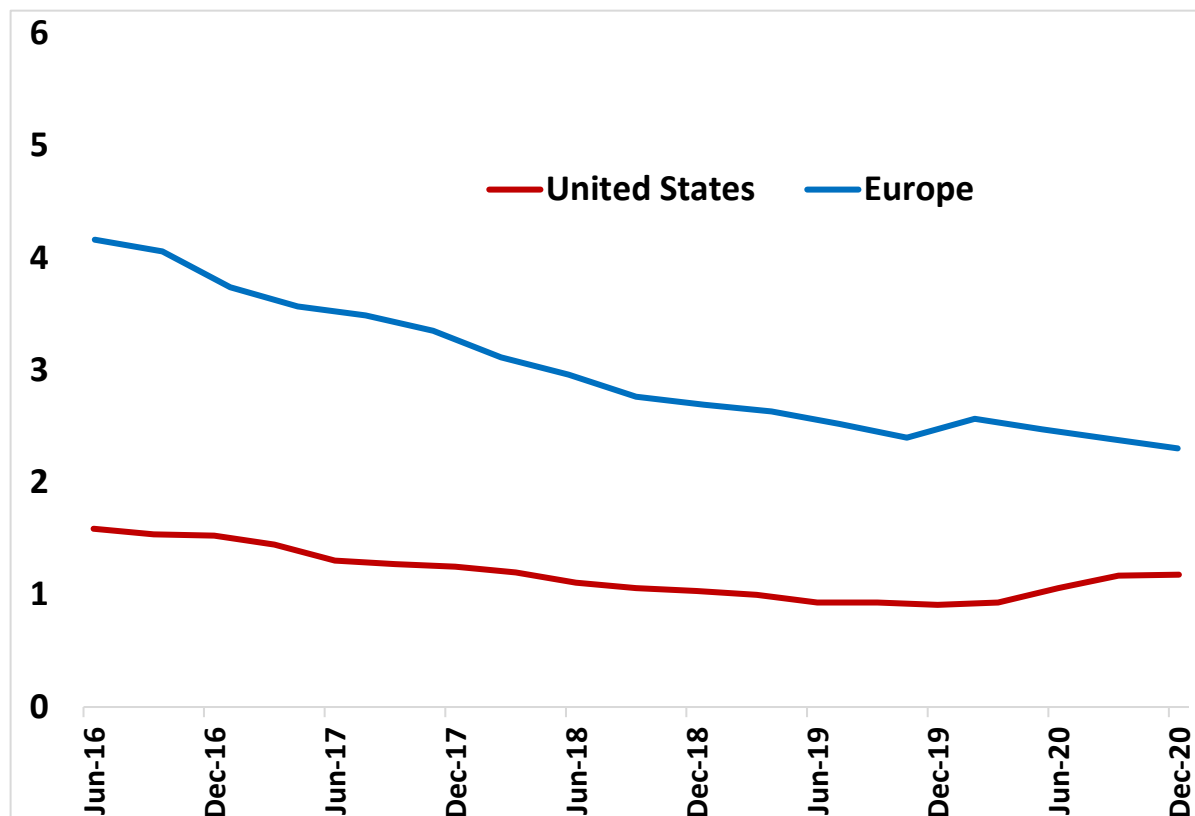
Immediately after the outbreak of Covid-19, prudential authorities took bold action to reduce incentives for banks to retrench on their willingness to provide credit to the private sector (BCBS (2020)). Their aim was to prevent uncoordinated responses by banks that could lead to a credit contraction, thus amplifying the harm done by the pandemic to the real economy.

The measures taken by supervisory authorities, when combined with supportive fiscal and monetary policy, undoubtedly helped mitigate the pandemic's impact on economic and financial stability. Yet these actions might have made banks' financial health more difficult to assess. Indeed, most of the relief measures directly affect the computation of regulatory capital, risk-weighted assets and asset quality indicators. The latter may be particularly significant. The flexibility provided for the classification of assets as non-performing or forborne makes it challenging for supervisors to monitor the evolution of asset quality. The extreme case is in jurisdictions, particularly in emerging market economies, that have gone as far as freezing the classification status of all credit exposures prior to Covid-19 (IMF and World Bank (2020)).

To some extent, those policy actions may be affecting the evolution of key indicators such as those for asset impairments. So far, ratios of non-performing exposures have barely been affected by the pandemic. In particular, in both the EU and the US they remain at very low levels (Graph 1) despite the substantial contraction of economic activity and employment in both areas. That, of course, could be partially explained by support measures for households and firms. Yet different practices followed by different banks may point to an incomplete assessment of creditors'

United States and Europe: non-performing exposures (% of total loans)

Graph 1

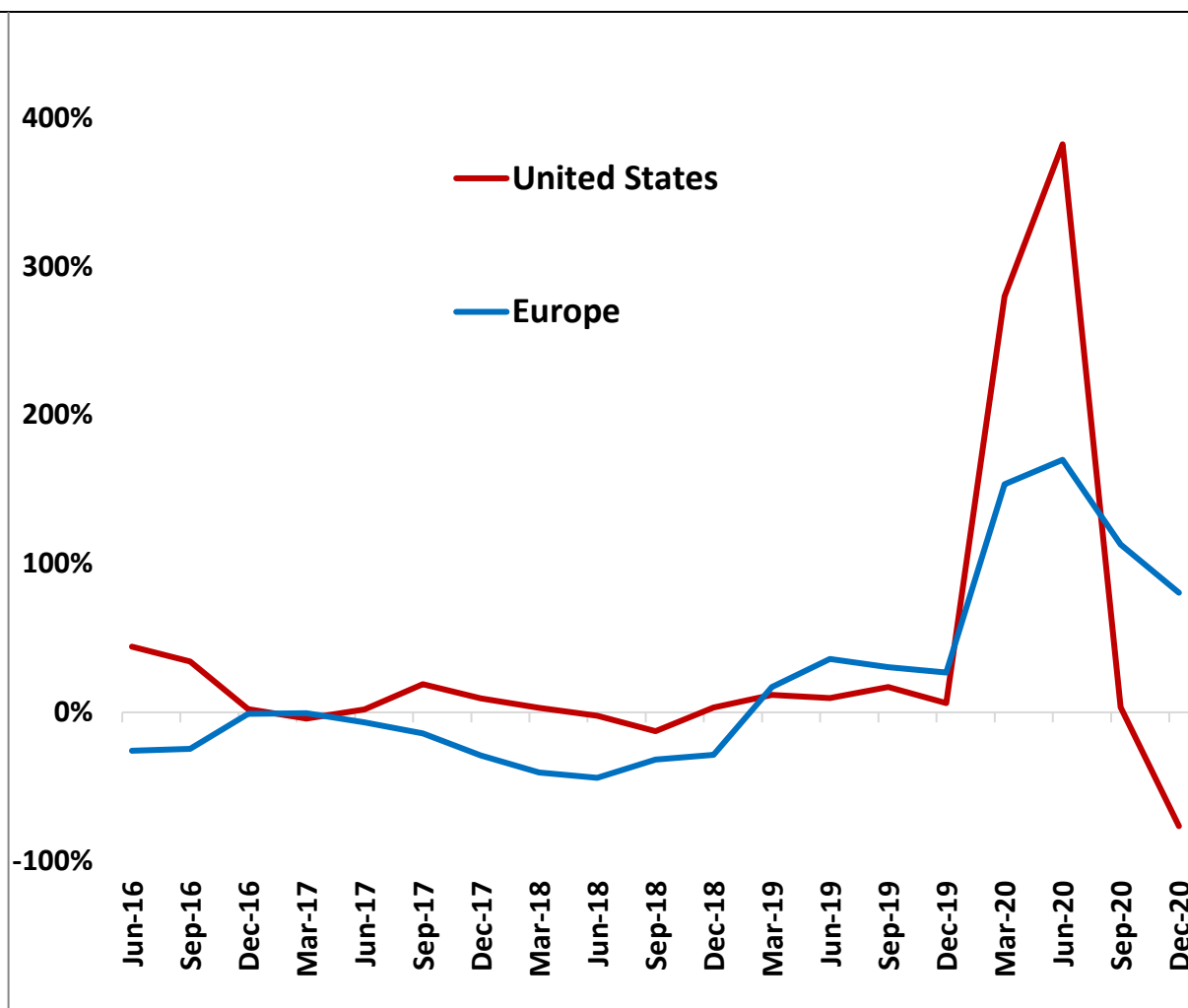


Source: Federal Reserve Board and ECB supervisory statistics.

The smooth evolution of non-performing exposures may, at least, partially justify the relatively moderate increase of loan loss provisions in most jurisdictions. While provisioning effort increased notably in both the EU and, especially, in the US in the first half of 2020, that extra effort was subsequently discontinued partially in the first case and fully in the second (Graph 2). The result is that accumulated loan loss reserves seem misaligned with the evolution of economic activity. Whether this could eventually result in a relevant capital impact of forthcoming defaults depends very much on authorities' ability to sustain the current support measures until economic conditions normalise. In any case, once again, heterogeneity of provisioning approaches across banks and jurisdictions make asset quality review processes a key priority for supervisors.

United States and Europe: provisions (yoy % change)

Graph 2



Source: Federal Reserve Board and ECB supervisory statistics.

That scrutiny of banks' specific situations and the way the pandemic is affecting their exposures is also essential to strike the right balance between the macro and micro dimensions of prudential policies. In order to keep consistency with a supportive macroprudential policy stance, supervisors need to encourage banks to maintain the supply of credit to the real economy. But, of course, that message should only be conveyed to those institutions with a financial position that allows them to take up risks. Weaker institutions may need to adopt a more conservative approach in order to cope with the stresses generated by the pandemic. That is why discrimination across institutions is key at the current juncture.

Well designed stress tests can be particularly helpful for supervisors to assess each institution's ability to absorb losses and continue providing credit (Baudino (2020)). Unlike in more stable conditions, those exercises become relevant, in the present circumstances, not only as a way to estimate resilience in a low-likelihood severely adverse scenario but also in the most likely (or baseline) scenario (Quarles (2021)). In particular, estimates of the balance sheet impact of the expected course of economic activity (including the evolution of support measures) do help

supervisors assess the extent to which loan loss reserves are sufficient to cope with the expected deterioration of assets and, therefore, whether banks' provisions – and not only capital – should be strengthened.

### 3. On regulatory challenges

Let me now turn to the regulatory challenges. By stress testing the financial sector, the pandemic is helping to show the extent to which the post-GFC regulatory framework is likely to achieve its objectives.

The first observation is that, as shown in the actual stress tests conducted in major economies, the financial system seems generally able to absorb the pandemic's impact even under the severe scenarios of a prolonged health crisis and economic contraction. This is largely thanks to the ample capital and liquidity buffers built up by financial institutions to comply with the Basel III reforms.

At the same time, the crisis has shown that other components of the post-crisis reforms may have had some unanticipated effects. For example, the expected credit loss provisioning standard was meant to reduce the procyclicality of banks' income by requiring them to anticipate loan loss provisions before actual delinquencies take place. The pandemic has shown that, while this normally the case, when there is an unexpected common shock, accounting rules based on expected losses tend to force all banks to sharply increase their provisions more or less at the same time. This convergence of provisioning efforts across time and entities may generate procyclicality. This explains why regulators – including accounting standard setters (IFRS (2020)) – have issued guidance for banks to apply the new standard in a pragmatic way and, in some cases, have opted to postpone the compulsory application of the new accounting rules.

Another important area for reflection by regulators is the Basel III buffer system, and how well it works. In particular, it makes sense to analyse whether buffers are contributing, as intended, to preserve minimum capital and mitigate the impact of the downturn on credit supply.

Table 1

	CAP REQUIREMENTS =						Sup buffers (SB)				
	P1	+	P2	+	SIB	+	CCoB	+	CCyB	+	<ul style="list-style-type: none"> <li>• P2G in BU</li> <li>• PRA-B in UK</li> <li>• STCB in US</li> </ul>
Basel III	✓		✓		✓		✓		✓		✗
Microprudential	✓		✓		✗		✓		✗		✓
Usable in bad times	✗		In some cases		✗		✓		✓		✓
Releasable	✗		✗		✗		✗		✓		✗
Penalties/restrictions	✓		✓		✓		✓		✓		In some cases

Legend: P1: Pillar 1 requirements; P2: Pillar 2 add-ons; SIB: (global or domestic) systemic buffer; CCoB: capital conservation buffer; P2G: Pillar 2 guidance buffer; PRA-B: PRA buffer; STCB: Stress-test capital buffer.

Source: Author's own compilation.

In the Basel Framework, Pillar 1 (P1) establishes the minimum capital all banks have to hold. Pillar 2 (P2) includes capital add-ons to cover entity-specific risks not captured in Pillar 1. In addition, all banks must meet a combined buffer requirement composed of a homogeneous capital conservation buffer (CCoB), a systemic risk buffer (SIB) if they meet specific criteria, and a countercyclical capital buffer (CCyB) that can be imposed and released by macroprudential authorities in response to economic developments and, especially, credit growth (FSI (2019)).

To judge how the buffer system is performing in the current crisis, it is necessary to acknowledge the wide variety of approaches followed in practice to establish buffers above the minimum capital requirements (Table 1). That heterogeneity arises in part from the different interpretations and calibrations of the Basel Pillar 2 (Duckwitz et al (2019)). In addition, discrepancies have emerged from the differences in national or jurisdictional overlays (supervisory buffers (SB)) above the Basel III capital stack.

In jurisdictions such as the European banking union, the United Kingdom and the United States, supervisors expect banks to meet additional buffers (P2 Guidance, PRA buffer and the stress test capital buffer, respectively), which are calculated as a function of the capital depletion that banks would suffer in the adverse scenarios of different types of supervisory stress tests. Those jurisdiction-specific buffers are set annually for each institution as part of the supervisory cycle and can be used to absorb unexpected losses.

A key feature of the current – arguably complex – buffer system is that the only instrument that plays a well defined macroprudential role is the CCyB. Indeed, its official magnitude is regularly calibrated by the supervisor as a function of prevailing economic conditions. The other buffers (such as the CCoB or supervisory buffers) are deemed to protect minimum capital in bad

conditions (they are mainly microprudential from that perspective), although they can also indirectly help mitigate corrections in credit supply. Although their official target size is not adjusted as a function of cyclical conditions, banks are allowed (or encouraged as at present) to temporarily deploy them to absorb losses in bad times without the need to constrain credit. The depletion of those buffers below the target size may be subject (as in the case of the CCoB) to restrictions on dividend payouts, coupons on Additional Tier 1 (AT1) instruments and variable remuneration for employees.

It is too early to conclude whether any aspect of the current framework needs adjustment. In particular, there is no firm evidence of any significant credit contraction that could be blamed on imperfect functioning of the buffers' macro-stabilisation function. Recently, there have been signs of downward adjustment in outstanding loan volumes and tighter credit standards,<sup>2</sup> but those are still in line with the evolution of banks' financing in other economic downturns.

At the same time, some developments could merit continued monitoring and analysis. First, the CCyB was intended to address economic contractions caused by the unwinding of macro-financial imbalances such as excessive credit growth. Since, in the recent past, credit has not been growing rapidly, the CCyB was already set at zero or a very low level in most jurisdictions. Thus, very little firepower remained to deploy against a purely exogenous shock that was unrelated to credit developments.

Second, as the CCyB proved unable to deliver the stabilising power required, regulators had to rely mainly on microprudential instruments to meet a macroprudential objective (Carstens (2020)). Concrete actions varied across jurisdictions, although they often consisted in asking banks to make use of their microprudential buffers (such as the CCoB and SB). So far, the result has not been entirely satisfactory, as banks have generally shown a reluctance to use their buffers.

This unwillingness may, of course, reflect the slightness of the impact (at least so far) of the pandemic on banks' solvency. That, in turn, may be due partly to the pandemic's limited impact on asset quality indicators, as I described earlier. However, several disincentives seem to exist that may make banks reluctant to use their buffers, even if they are facing significant capital pressure.

In particular, since the Basel III buffer depletion is subject to automatic remuneration restrictions for instruments qualifying as regulatory capital, banks may fear that the market price of those instruments will be undermined if they reduce their capital levels below the buffer thresholds. In addition, the binding constraint for regulatory capital is not necessarily the prudential requirement. Global systemically important banks (G-SIBs) are subject to loss-absorption requirements (ie the total loss-absorbing capacity (TLAC) standard) aiming at facilitating their resolution in case of failure. Those requirements have not been modified following the pandemic's outbreak. Banks may therefore be unwilling to reduce their equity levels – by consuming their prudential buffers – if they still need that equity to meet TLAC requirements.

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<sup>2</sup> Lending surveys show a tightening of lending standards as of Q2 2020 in the EU (Euro Area Bank Lending Survey) and Q3 2020 in the US (Senior Loan Office Survey).

More importantly, the uncertain financial and economic environment makes markets sensitive to any development affecting banks' ability to withstand adverse developments without replenishing their capital. In these conditions, investors may penalise any capital reductions below the regulatory references, even if this is supported by supervisory guidance.

This market stigma is likely to be particularly pronounced in jurisdictions, such as the European Union, where the profitability of financial institutions and their market valuations are depressed due to the sector's excess capacity (Restoy (2018)). Low profits indicate that banks are finding it difficult to generate capital internally. Similarly, low price-to-book values indicate the heavy price that banks would have to pay to attract more equity capital. Available capital becomes particularly precious in these jurisdictions. This suggests that overbanking may affect not only market efficiency and, potentially, financial stability, but also banks' ability to use their capital to smooth out fluctuations in credit supply. This macroprudential argument further supports a proactive approach by authorities to facilitate an orderly consolidation.

In any event, all this suggests that supervisors' willingness to accept a temporary use of the buffers to absorb losses may not suffice to keep the credit supply at adequate levels. These developments will need to be carefully examined by regulators and international standard-setting bodies to assess whether refinements of the current framework would be warranted.

In this regard, there could be several options for improving the current framework.

One conservative approach would be to work on the actual penalties faced by banks if they use buffers. In particular, it could be considered whether current constraints on the remuneration of holders of equity or other instruments – such as AT1 – have unintended effects when bank capital falls below specific thresholds. However, removing these restrictions may be inconsistent with the required loss-absorption nature of all instruments qualifying as regulatory capital. Moreover, as argued above, that strategy would not address the plurality of factors, including market stigma, that feed into banks' apparent unwillingness to make use of their capital buffers.

A more ambitious approach would be to establish a larger macroprudential buffer that could be released at discretion during bad times. Such a buffer would replace the current CCyB and would have a positive level in normal times in order to accommodate unexpected shocks such as a pandemic.<sup>3</sup> This adjustment of the current framework would allow objectives and instruments to be more clearly aligned. The macroprudential buffer would be set exclusively on macroprudential policy grounds (eg to help keep up an orderly provision of credit to the real economy) while the microprudential buffers (CCoB and SB) would be calibrated to meet purely microprudential objectives, ie to ensure that individual financial institutions have sufficient capital in all phases of the economic and financial cycle.

Arguably, that proposal could entail some transfer of powers from microprudential to macroprudential authorities. Moreover, for international banks, the host authorities would have

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<sup>3</sup> A non-zero CCyB in normal times is the approach currently followed in the United Kingdom. Quarles (2019) and Hernández de Cos (2020) support further reflection on the merits of this approach. See also Behn et al (2021).



more influence on capital requirements for the group, as they would set the macroprudential buffer for both domestic banks and subsidiaries of foreign banks.

Those political economy considerations may become particularly significant in the European banking union. At present, the microprudential responsibility is effectively centralised in the ECB through the Single Supervisory Mechanism. At the same time, the macroprudential responsibilities remain largely decentralised, although the ECB can top up measures taken at the national level. The idea of moving resources in normal times from microprudential to macroprudential buffers, thus enhancing the role of macroprudential authorities in setting capital requirements, may need to be supported by a strengthening of the ECB's macroprudential policy role. Otherwise, additional challenges may emerge for adequate coordination between the micro- and the macroprudential policy functions.

#### 4. Concluding remarks

That regulators have accepted an explicit macro-stabilisation role is to be welcomed. This builds directly on one of the main lessons from the GFC: authorities should aim not only to preserve the safety and soundness of individual financial institutions but also to keep credit flowing to the real economy through all phases of the cycle.

Yet the Covid-19 crisis has shown just how challenging that task is in practice. From a supervisory viewpoint, it is a challenge to keep up an effective oversight of banks and address pockets of vulnerability while maintaining a supportive macroprudential stance.

Certainly, adjustments in regulation – particularly to strengthen macroprudential frameworks – may help to address those challenges by providing authorities with more and better tools. Yet regulatory adjustments can only take place once sufficient evidence is on hand for the issues that need to be tackled, so that a thorough analysis can be performed.

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