CENTRO EUROPA RICERCHE

European Parliament – Committee on Economic and Monetary Affairs

Public Hearing on the Covid-19 outbreak, its expected impact on the EU economy and possible policy responses including monetary and fiscal measures

Monday 15 June 2020, 15.45-18.45

Panel 2 (17.05-18.45) – Possible economic policy responses to the COVID-19 outbreak including monetary and fiscal measures

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Introductory statement:

The Covid-19 crisis and the European Banking Union: it's time for a much needed fix

Our subject is a very challenging and also a very broad one.

I will focus on the banking sector and its lending activities.

I'll deal with this topic for 2 reasons:

1) First of all, it's a key issue. As the EBA pointed out in a recent paper, "asset quality is expected to deteriorate significantly" [1] in the coming months, due to a probable steep rise in NPLs; but, on the other hand, we know that lending activity is a critical factor in order to enable a quick and sound economic recovery – and therefore it should be supported and not discouraged;
2) Secondly, I'm firmly convinced that in order to reduce the economic pain in the next months/years, we must avoid repeating past mistakes and correct some apparent shortcomings in the European banking union regulation.

To 1): Policy makers are well aware of the strategic importance of lending in the current economic environment.

- ECB acted very quickly, providing abundant liquidity to the banks (TLTROIII, the new PELTRO etc.).
- ECB Banking Supervision authorized a temporarily easing of some requisites (Pillar 2 Guidance, Capital Conservation buffer and LCR).
- The EP and the European Council provided a quick fix of CRR2, containing some useful correction to the previous text.

But further efforts should be made in order to enhance the resilience of European banking system in coming months.

I mean in particular:

- temporary amendment to Regulation 2019/630 of the Parliament and of the Council of 17 April 2019 as regards minimum coverage of losses on non-performing exposures: a delay

[1] The EU banking sector: first insights into the Covid-19 impacts, EBA, Thematic note EBA/REP/2020/17

in Calendar provisioning by two years is needed (in other terms, the current provisioning curves for NPLs should be deferred for 24 months),

- more substantial delay of the new definition of default would be necessary, too (the new date agreed, 1.1.2021, is still too close).

Otherwise, as a recent draft opinion by the European Economic and Social Committee pointed out, banks would be forced to comply with "rules which could ultimately exert enormous pressure on capital or at least discourage banks from issuing financing in an economy under strain in order to avoid negative repercussions on capital".[2]

The need for a delay in applying rules approved only recently can be disturbing.

But there is a serious reason for this: these rules are pro-cyclical.

So I come to my second, more general point:

To 2): Well beyond the current emergency, we can raise some doubts on the philosophy underlying the European banking regulation after the Great Recession, and more particularly since the inception of the European banking union.

Let me sum up this philosophy in a few key principles:

a) Concentration is the royal road to competition on a global scale

b) One size fits all

c) Strong oversight of credit risk is needed, much less for market risk

d) Derisking is an absolute priority.

Just a few words on each of these principles – or dogmas:

a) Concentration as *the* solution to competition issues.
As a matter of fact European banking sector already underwent a huge concentration process in the last years: in 2013 EU banks were 8,000, in 2019 they were 3,400.[3]
If we assume that this process continues at the same pace, in 2025 there will be less than 1,500 banks in the EU.
I don't think that such an outcome would be something worth wishing for.
Economies of scale actually aren't the only way to successfully compete
(in the FinTech era, brainpower and the capability to attract capital aren't less important).
Furthermore: some "necessary" economies of scale were created by regulation itself.
More precisely: by

b) the One size fits all dogma.

[2] *"Proposal for a Regulation of the European Parliament and of the Council amending Regulations (EU) No 575/2013 and (EU) 2019/876 as regards adjustments in response to the COVID-19 pandemic"* [COM(2020) 310 final – 2020/0066 (COD)], European Economic and Social Committee – Draft opinion, 29/05/2020 (approved by the plenary session: 10-11/06/2020).

[3] R. Masera, *Community banks e banche del territorio: si può colmare lo iato sui due lati dell'Atlantico?*, Roma, Ecra, 2019, p. 25.

If we don't uphold the principle of proportionality in applying an increasingly complex regulation,
if we don't differentiate compliance costs in accordance with the different size of the banks, this will raise costs for little banks above the level at which profitability can be attained.
On the other hand, the current regulation enables big banks to use less capital than the little ones for the same activities (e.g., covering interest rate risk is for minor banks more expensive, due to the impossibility for them to use internal rating models).
To put it simply, we are currently forcing concentration through regulation.
I'm well aware that many regulators and supervision entities, in Frankfurt as well as in many European national capitals, think that this is the way for European banking to be competitive at a global level, that is with US big banks.
Such an approach seem to forget that right in the US a few very big banks coexist with banks of different sizes (among them many community banks)[4] that are ruled on the basis of a proportionality principle (less rules, lower capital standards than bigger banks, etc.).
In this respect the new definition of "small or less-complex entities"[5] introduced in CRR2 can be a step in the right direction, but so far only a few exemptions were introduced for these banks.
Thus the *dimensional bias* in EU banking regulation was mitigated only to a small extent.

c) <u>Strong oversight of credit risk, much less of market risk</u>.
Beside the dimensional bias, there is also a *functional bias*.
As you may know, in the first 4 years of the new ECB Banking Supervision, market risk was <u>never</u> one of the five top priorities for ECB Supervisory activities on European banks, while credit risk was <u>always</u> a priority.
Principle here is: we need less lending by banks, more capital from the capital market.
Consequence is: the use of capital for finance is favored, the use of capital for lending is discouraged.
Here we must be aware that:
– today the biggest source of systemic risk for banks in Europe is market risk, not credit risk;[6]
– finance can't be the only game in town. We need banks that lend to non-financial firms and families. No Capital Market Union is at present (nor will be in a foreseeable future) an adequate substitute for this.

d) Last principle: <u>Derisking is an absolute priority</u>.
This was sensible in the aftermath of 2008/9 crisis, and it sounds good.
But an important disclaimer is needed here, too:
through regulation you can control risk, but you can't avoid risk at all.
I actually think that precisely the ingenuous hope in a regulation capable of getting rid of risk at all led to the increasingly complicated network of capital rules, to the increasingly stronger and binding prudential backstop mechanisms that were imposed to the European banking system in the last years. In some cases - as in Italy in 2015/2016 – this new set of rules had

[4] Defined as banks with total assets < $ 1 billion.
[5] Banks with total assets < € 5 billions.
[6] See A. Forte, *Rischio di mercato e rischio sistemico ai tempi del coronavirus: quali sono le banche europee più esposte*, CER, Current issues, 27 march 2020. It's no accident that part of the regulation concerning market risk was eased once the financial turmoil began.

destabilizing effects on banking business, setting in motion a dangerous loop of self-reinforcing processes and self-fulfilling prophecies.

Conclusion. Crises are times for immediate action, but are also opportunities for a more strategic reshaping and restructuring: of companies, industries, and sometimes societies as a whole.

This crisis is no exception. The economic landscape of the European Union at the end of the current crisis will be very different from the present one.

We should take the opportunity to rethink the approach that prevailed in establishing the European banking union, and to give up the 4 dogmas mentioned above.

I think that only if we'll succeed in doing so our banking system will be able to give its contribution to the necessary economic recovery, instead of becoming part of the problem.