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The relaxation of bank capital and liquidity requirements in the wake of the coronavirus crisis

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The relaxation of bank capital and liquidity requirements in the wake of the coronavirus crisis

Abstract

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LIST OF ABBREVIATIONS

BCBS	Basel Committee on Banking Supervision
CCoB	Capital conservation buffer
CCyB	Countercyclical capital buffer
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
EBA	European Banking Authority
ECB	European Central Bank
ESRB	European Systemic Risk Board
EU	European Union
FASB	Financial Accounting Standards Board
G20	The Group of Twenty
GDP	Gross domestic product
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
LCR	Liquidity coverage ratio
NFSR	Net stable funding ratio
NPL	Non-performing loan
PD	Probability of default
PIT	Point-in-time
SSM	Single Supervisory Mechanism
TTC	Through-the-cycle
US	United States

EXECUTIVE SUMMARY

EU banks entered the coronavirus crisis with high capital and liquidity buffers resulting from the regulatory reforms undertaken after the global financial crisis of 2007-2009. This allowed for a bold and swift response by supervisors oriented towards supporting banks' ability to provide credit to the real economy.

This paper provides an overview and an assessment of the regulatory response to the crisis, and suggests some lessons that can be learned from the experience. First, the macroprudential tools in the current banking regulation are clearly insufficient to deal with large macroeconomic shocks. Second, the new framework for provisioning based on expected credit losses adds an additional layer of procyclicality to the one derived from the risk-sensitive bank capital regulation. Third, given the overall procyclicality of the regulation, an institutional design in which microprudential supervision is close to the central bank is highly desirable, so that microprudential tools can be quickly deployed for macroprudential purposes.

The paper concludes with the following policy recommendations. First, the credit-to-GDP gap should be abandoned as the common reference point for the countercyclical capital buffer, because it tends to give wrong signals. Moreover, given that there is no good single indicator of systemic risk, macroprudential authorities should use solid macro-financial analysis and sound judgement as the basis for setting the buffer. Second, banking regulation should be rebalanced in order to increase macroprudential buffers; in particular, the upper bound of the countercyclical capital buffer could be raised from 2.5% to 4% and, to partially compensate this increase, the capital conservation buffer could be reduced from 2.5% to 2%. Third, it would be desirable to use a single statistical framework in the calculation of the through-the-cycle (TTC) risk measures used to compute capital requirements and the point-in-time (PIT) measures used to compute loan loss provisions. Finally, to mitigate the procyclical effects of the new accounting standards, it would be worth considering expanding the current prudential filters that separate accounting from regulatory capital.

1. INTRODUCTION

In the beginning was the global financial crisis of 2007-2009—and the response by the authorities, led by the G20. The Declaration of the Washington Summit on Financial Markets and the World Economy that took place on 15 November 2008 stated: "We must lay the foundation for reform to help to ensure that a global crisis, such as this one, does not happen again." In addition to agreeing on some common principles for reform, the Leaders of the G20 requested their Finance Ministers to formulate recommendations in the following specific areas:

1. Mitigating against pro-cyclicality in regulatory policy.
2. Reviewing and aligning global accounting standards.
3. Strengthening the resilience of credit derivatives markets.
4. Reviewing compensation practices.
5. Reviewing the mandates of the International Financial Institutions.
6. Determining the appropriate regulation of systemically important institutions.

Interestingly, the first item on the list was addressing the issue of procyclicality in regulatory policy. And, as we will see below, the second item was also connected with the same issue.

Following on these recommendations, the Declaration on Strengthening the Financial System, agreed at the G20 London Summit of 2 April 2009, provided further details on previous commitments. In particular, it stated that "capital buffers above the required minima should be allowed to decline to facilitate lending in deteriorating economic conditions," and instructed the Basel Committee on Banking Supervision, as well as accounting standard setters, to implement their recommendations "to mitigate pro-cyclicality, including a requirement for banks to build buffers of resources in good times that they can draw down when conditions deteriorate."

Finally, at the Pittsburgh Summit of 24-25 September 2009, the G20 Leaders declared: "We commit to developing by end-2010 internationally agreed rules to improve both the quantity and quality of bank capital and to discourage excessive leverage. These rules will be phased in as financial conditions improve and economic recovery is assured (…) The national implementation of higher level and better quality capital requirements, counter-cyclical capital buffers, higher capital requirements for risky products and off-balance sheet activities (…) together with strengthened liquidity risk requirements and forward-looking provisioning, will reduce incentives for banks to take excessive risks and create a financial system better prepared to withstand adverse shocks."

With an amazing speed, in December 2010 the Basel Committee published two documents titled "Basel III: A global regulatory framework for more resilient banks and banking systems" and "Basel III: International framework for liquidity risk measurement, standards and monitoring," containing a comprehensive reform package following the guidelines of the G20. Most of the provisions of Basel III were also quickly incorporated in the EU Capital Requirements Directive (CRD IV) and the US Final Rule on Regulatory Capital, both dated July 2013.

The accounting standard setters were slower in completing the task of implementing forward-looking provisioning, but both the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) agreed in 2014 and 2016, respectively, on a shift from the traditional incurred loss approach to an expected credit loss approach to loan loss provisions.

Summing up, addressing the potential amplification effects of banking regulations was one of the key drivers of the G20 response to the global financial crisis. Thus, the coronavirus crisis can be considered as the first real test of the new regulatory framework. From this perspective, the current crisis can provide useful lessons for the future.

This briefing paper discusses the effectiveness of the new regulatory framework in light of the response to the coronavirus crisis. Sections 2 and 3, respectively, summarise the main changes to capital and liquidity regulation, on the one hand, and to loan loss provisioning rules, on the other. Section 4 discusses the distinction between the microprudential and the macroprudential approaches to financial regulation, as well as the potential conflicts between them. Section 5 provides an overview of the state of the European banking system before the crisis. Section 6 summarises the response of the European Union policy makers to the outbreak of the pandemic, focussing on the regulatory and supervisory front. Section 7 assesses the effectiveness of this response. Section 8 concludes with a discussion of some lessons for the future. However, at the point of writing this paper, the crisis is still underway, so the assessment and the lessons should be taken as tentative.

2. THE CURRENT FRAMEWORK FOR CAPITAL AND LIQUIDITY REGULATION

Basel III introduced many changes to the previous 2004 framework, known as Basel II, which we are not going to describe in any detail (the latest compilation by the Basel Committee has 1,627 pages). Rather we focus on the features of Basel III that have a bearing on the issue of procyclicality.

The structure of the capital requirements is, in principle, simple: the ratio between capital and risk-weighted assets should be greater than a given minimum. In practice, there are two critical issues, namely, what exactly is counted as capital and how the risk-weights are to be computed. Basel III introduced a more restrictive definition of common equity, higher risk-weights for some assets, and a higher minimum requirement in terms of common equity (4.5%) and Tier 1 capital (6%). In addition, it introduced two buffers, the capital conservation buffer (CCoB) and the countercyclical capital buffer (CCyB) that increase the minimum requirements by 2.5% and up to 2.5%, respectively. The CCyB extends the CCoB, which is a buffer in the sense that it could be breached, although in this case restrictions on earnings distributions (dividends, share repurchases, and bonus payments to executives) apply. Finally, on the capital front, Basel III introduced a non-risk-based leverage ratio of 3% that was intended as a backstop for the risk-based capital requirements.

Perhaps the most significant departure of Basel III from Basel II was the introduction of a novel liquidity regulation in the form of two complementary standards. The liquidity coverage ratio (LCR) essentially requires a bank's liquid assets to cover its unstable sources of funding (e.g. short-term wholesale borrowing). The net stable funding ratio (NSFR) essentially requires that a bank's illiquid assets are funded with stable sources of funding (e.g. equity capital or long-term debt).

To assess the potential procyclical effects of bank capital regulation it is important to bear in mind that the main rationale of Basel II was to make capital requirements more sensitive to risk, so that a bank with a riskier portfolio would be required to have more capital. However, there was a flip side to providing a better alignment of capital requirements with banks' risks, namely the fact that this regulation could amplify business cycle fluctuations. In particular, in recessions, losses erode banks' capital, while risk-sensitive capital requirements go up. If banks cannot quickly raise sufficient new capital, they would be forced to reduce their lending, thereby contributing to the worsening of the downturn.

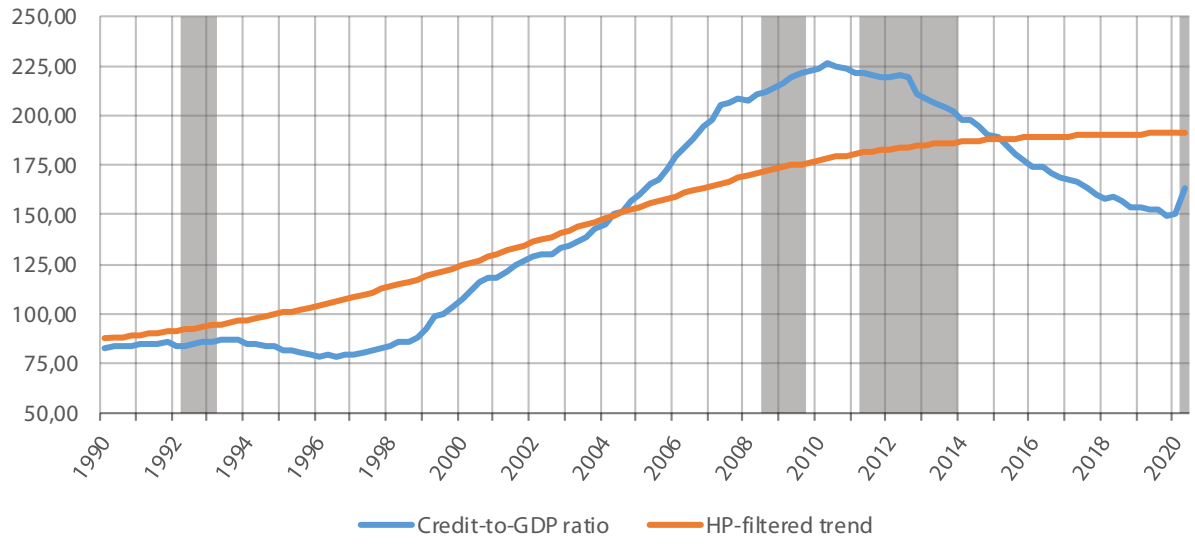
Discussions on the possible business cycle amplification effects of Basel II started at an early stage; see for example Kashyap and Stain (2004) and Gordy and Howells (2006), a paper with a revealing title: "Procyclicality in Basel II: Can we treat the disease without killing the patient?" The reaction to these concerns by the Basel Committee was basically dismissive: "It is not possible to achieve a greater risk sensitivity across institutions at a given point in time without introducing a certain degree of cyclicality in minimum capital requirements over time" (BCBS, 2010).

Perhaps the only dimension in which there was a response to concerns on procyclicality was in the gradual shift by supervisors from a point-in-time (PIT) to a through-the-cycle (TTC) approach to the computation of the capital requirements. To explain the difference between these two approaches, consider a large bank using its internal ratings to assess the probability of default (PD) of a corporate loan in its portfolio, which is the basic input to compute the Basel II capital requirement corresponding to the loan. In a PIT approach, the PD will be a conditional assessment of risk that takes into account the current economic and financial firm data as well as the current macroeconomic environment. In a TTC approach, the PD will be an unconditional assessment of risk that takes into account the average firm and macroeconomic data over the course of a business cycle.

As noted above, to avoid a possible credit crunch when the economy enters a recession, Basel III introduced the CCoB and the CCyB. With respect to the CCoB, evidence so far is that banks are very reluctant to use the flexibility provided by the buffer and treat it effectively as a higher minimum requirement; see Andreeva et al. (2020). With respect to the CCyB, the problem is even greater.

The stated objective of the CCyB is not directly linked to ameliorating the procyclicality of capital regulation but rather "to achieve the broader macroprudential goal of protecting the banking sector from excess credit growth" (BCBS, 2010). Moreover, the Basel Committee decided to propose the use of the aggregate private sector credit-to-GDP gap as the common reference point for taking buffer decisions. The credit-to-GDP gap is defined as the deviation of the credit-to-GDP ratio from its trend. Figure 1 illustrates the computation of the gap in the second quarter of 2020 for Spain. The blue line represents the evolution of the credit-to-GDP ratio, while the orange line represents its trend. According to the Basel guidance, the CCyB should be activated when the gap reaches 2pp, increasing linearly thereafter until it reaches the maximum 2.5% for a value of the gap of 10pp.

Figure 1: Evolution of the credit-to-GDP ratio and its trend in Spain, 1990-2020



Note: Shaded areas represent recessions in Spain. Source: Bank of Spain.

From the very beginning, some of researchers noted that the credit-to-GDP gap posed a number of problems. For example, Repullo and Saurina (2012) showed that "the correlation between the credit-to-GDP gap and GDP growth is generally negative, which means that that the gap would tend to give a signal to reduce capital requirements when GDP growth is high, and to increase capital requirements when GDP growth is low." For this reason, they concluded that "the countercyclical capital buffer of Basel III, in its current shape, will not help to dampen the procyclicality of bank capital regulation and may even exacerbate it."

Unfortunately, the Capital Requirements Directive (CRD IV) introduced the CCyB as proposed by the Basel Committee and established that the European Systemic Risk Board (ESRB) be responsible for providing, by the way of recommendations, guidance to authorities designated in Member States on setting CCyB rates as well as on the measurement and calculation of the credit-to-GDP gap. Interestingly, there was no reference to the gap in the US Final Rule on Regulatory Capital.

As for the liquidity requirements of Basel III, they have less bearing on the overall procyclicality of the regulation, given that in good times they will, if anything, constrain credit growth, and that in bad times they are unlikely to be binding, since liquidity might be flying to the safety of the insured banking system and central banks will normally provide ample liquidity in downturns. Still, following a negative macroeconomic shock, some banks may face liquidity problems, but they would tend to be associated with concerns about the impact of the shock on their solvency.

3. THE CURRENT FRAMEWORK FOR LOAN LOSS PROVISIONING STANDARDS

Provisioning rules prior to the global financial crisis obliged banks to recognise credit losses only when they had already been incurred, without considering those expected to emerge in the future. By delaying banks' recognition of credit losses, loan loss provisions under this standard were criticised for being "too little, too late," and a potential source of procyclicality. As noted above, following the call of the G20 to develop a forward-looking approach to provisioning standards, the IASB introduced in 2014 new rules based on the concept of expected loss, which entered into force in 2018 with the adoption of the International Financial Reporting Standards 9 (IFRS 9).

IFRS 9 calls for the recognition of credit losses expected to emerge over horizons varying from one year to a credit instrument's lifetime, by incorporating a broader range of current information, including macroeconomic conditions. Under IFRS 9, each loan in the portfolio of a bank has to be classified in one of three distinct categories depending on its credit quality. These categories, in turn, determine the horizon over which future expected losses have to be estimated. For loans whose credit quality has not deteriorated since their inception (stage 1), expected losses need to be estimated within a one-year horizon. For loans with deteriorated credit quality (stage 2) or already impaired (stage 3), expected losses need to be estimated for their remaining lifetime until maturity.

This forward-looking approach was intended to force banks to start provisioning for future losses during good times, to be in a sounder financial position once losses start to materialise during bad times. The general perception, thus, was that the expected credit loss approach would increase transparency and the reliability of bank capital as a measure of solvency, induce a more cautious lending behaviour, and facilitate prompt corrective action.

Early on, however, concerns emerged about the procyclical implications of expected credit loss provisions, in general, and IFRS 9, in particular. Contrary to the current computation of capital requirements, which follow a TTC approach, the probabilities of default used in the calculation of future

expected losses follow a PIT approach. This implies that these estimates have to be updated based on currently available information and thus are highly sensitive to changes in borrower solvency and macroeconomic conditions. Moreover, the increase in the provisioning horizon for exposures that shift from stage 1 to stage 2 (the so-called "cliff effect") makes IFRS 9 expected loss provisions more sensitive to the arrival of a recession, when the solvency of bank borrowers, and thus the credit quality of loan portfolios, tends to deteriorate.

For this reason, absent the capacity of banks to anticipate adverse shifts in macroeconomic conditions sufficiently in advance, the upfront recognition of future expected losses right at the beginning of economic downturns may imply that, paradoxically, banks suffer a more abrupt fall in current profits than under the old incurred loss paradigm; see Abad and Suarez (2018). For banks constrained by capital requirements and unable to raise new equity, the subsequent deterioration of their capital position may reduce their lending capacity.

Even though this concern was not shared by most analysts during the development and implementation phases of the new standard, it clearly became apparent to regulators and supervisors soon after the outbreak of the coronavirus pandemic; see, for example, BCBS (2020) and ECB (2020b). The unexpected nature of this shock, which caused an abrupt contraction in economic activity, would require banks to suddenly increase their estimations of expected credit losses. This could lead to a contraction in the supply of credit right at the time when the provision of credit was most needed.

4. THE MICROPRUDENTIAL AND THE MACROPRUDENTIAL PERSPECTIVES

One of the most significant achievements after the global financial crisis was to the introduction of a macroprudential approach to banking regulation and supervision, as a complement to the traditional microprudential approach, which focuses on the state of individual banks.

The distinction between the two approaches is explained by Hanson, Kashyap, and Stein (2011) in the following terms: "When a microprudentially oriented regulator pushes a troubled bank to restore its capital ratio, the regulator does not care whether the bank adjusts via the numerator or via the denominator—that is, by raising new capital or by shrinking assets. (…) Such indifference to the method of adjustment makes sense if we are considering a single bank that is in trouble for idiosyncratic reasons. However, if a large fraction of the financial system is in difficulty, a simultaneous attempt by many institutions to shrink their assets is likely to be more damaging to the economy."

These different perspectives on regulation imply the possibility of a conflict between the microprudential and the macroprudential authorities in dealing with a downturn. While the former will be concerned about potential bank failures and therefore will be averse to relaxing capital requirements, the latter will be concerned about the effect of a credit crunch triggered by the regulation that will worsen the downturn.

This conflict essentially reflects that there is a fundamental trade-off: safer banks come at the expense of tighter credit conditions. In addressing this trade-off, the institutional design of the two authorities is key. We will come back to this in the context of the EU regulatory response to the coronavirus crisis.

5. EU BANKS BEFORE THE CORONAVIRUS CRISIS

The regulatory reforms undertaken after the global financial crisis implied that EU banks entered the coronavirus crisis with much higher capital and liquidity buffers. Capital ratios were well above

minimum regulatory requirements, rising from an average 9% in 2009 to almost 15% in 2019, while liquidity coverage ratios were close to 150% in 2019 (EBA, 2020b).

With regard to the macroprudential policy stance, and in particular the CCyB, it is important to note that the decision to activate or release it corresponds to the national competent authorities. This is justified by the fact that macroeconomic and financial conditions may not be synchronised across countries.

Despite enjoying a few years of economic expansion, by early 2020 the CCyB had never been raised from zero in 16 out of 27 member states, namely Austria, Croatia, Cyprus, Estonia, Finland, Greece, Hungary, Italy, Latvia, Malta, Netherlands, Poland, Portugal, Romania, Slovenia, and Spain. With regard to the two largest EU economies, Germany only announced an increase of the CCyB rate to 0.25% in mid-2019, which was later revoked in early 2020 before ever being implemented, while France increased its CCyB rate to 0.25% in mid-2018 and to 0.5% in early 2019, with the latter increase never implemented either.[1]

Arguably, the main reason for the absence of significant macroprudential buffers was the use of the credit-to-GDP gap as the common reference point for taking buffer decisions. Figure 1 clearly illustrates the shortcomings of the gap as a countercyclical indicator in the Spanish case. In particular, the gap was positive (and large) throughout the global financial crisis and the subsequent European sovereign debt crisis, while it has been negative (and large) since 2015, including years in which Spanish economy was growing above 3%.

Summing up, by early 2020, the EU banking system had a strong solvency and liquidity position, but there were very limited macroprudential tools that could be used when confronting a macroeconomic shock such as the one brought about by the coronavirus crisis. Hence, to avoid a credit crunch, microprudential tools were the only game in town.

6. THE REGULATORY RESPONSE TO THE CRISIS

The EU's economic policy response to the coronavirus crisis was swift and comprehensive, with remarkable coordination among fiscal, monetary, and regulatory measures.

On the fiscal front, European governments launched a variety of generous household income support as well as employment and lending schemes oriented towards keeping jobs and firms alive. At the same time, EU institutions put forward ambitious plans for the provision of favourable loans and public guarantees to serve as temporary relief to workers, businesses, and Member States, as well as to fund recovery and resilience plans with the €750 billion Next Generation EU Fund.

On the monetary front, the response of the European Central Bank (ECB) comprised a combination of significant extensions to existing programs and facilities such as the targeted long-term refinancing operations and the introduction of large new ones such as the €1,350 billion pandemic emergency asset purchase program. These measures were complemented by a temporary relaxation of the collateral eligibility requirements for liquidity providing operations and the reactivation of swap lines with other central banks.

On the regulatory front, which is the focus of this briefing paper, soon after the outbreak of the crisis and the adoption of confinement measures in Europe, microprudential and macroprudential supervisors announced unprecedented capital, liquidity, and operational relief measures, making full

[1] The historical evolution of CCyB rates can be found at https://www.esrb.europa.eu/national_policy/ccb/html/index.en.html.

use of the flexibility provided for in the regulatory framework. The key goal of these measures was to support banks' ability to provide additional credit to the real economy.

The ECB, in its role as microprudential supervisor within the Single Supervisory Mechanism (SSM), announced in March 2020 a broad set of measures providing temporary regulatory relief in response to the coronavirus crisis. In the words of Andrea Enria, Chair of the ECB Supervisory Board: "The coronavirus is proving to be a significant shock to our economies. Banks need to be in a position to continue financing households and corporates experiencing temporary difficulties. The supervisory measures agreed today aim to support banks in serving the economy and addressing operational challenges, including the pressure on their staff" (ECB, 2020a).

The measures allowed banks to operate temporarily below the level of capital defined by the CCoB and the so-called Pillar 2 Guidance (the additional capital buffer recommended to withstand stressed situations as assessed on the basis of the adverse scenario of the supervisory stress tests). They also allowed banks to use instruments other than common equity to meet the so-called Pillar 2 Requirements (a capital requirement for risks that are underestimated or not covered by the minimum capital requirement).

On the liquidity front, the ECB allowed banks to operate below the 100% LCR requirement, and announced a flexible approach when approving LCR restoration plans which banks are legally required to submit when breaching the requirement. Guidance about the timeline to restore buffers implied that banks would be allowed to operate below the LCR without automatically triggering supervisory actions until at least the end of 2021.

The ECB announced that supervisors would deploy full flexibility when discussing the implementation of non-performing loan (NPL) reduction strategies, and would consider measures such as adjusting timetables, processes and deadlines, on an individual bank-by-bank basis. It also announced increased supervisory flexibility regarding the regulatory treatment of loans receiving government support through payment moratoria and public guarantees. Other operational relief measures contemplated rescheduling on-site inspections, relaxing reporting requirements, and extending deadlines for the implementation of remediation actions stemming from recent on-site inspections and internal model investigations.

On the macroprudential front, the ECB also recommended that the national macroprudential authorities reduce the CCyB and other buffers, although for the reasons noted above the contribution of these measures to the overall lending capacity of EU banks was rather modest.

Regarding accounting standards, regulators and supervisors suddenly became aware of the potential procyclical effects of expected credit loss provisions. The ECB stated in its 20 March 2020 press release that "excessive volatility of loan loss provisioning should be tackled at this juncture to avoid excessive procyclicality of regulatory capital and published financial statements," explicitly recognising that "IFRS 9 model outcomes may be excessively variable and procyclical." In accordance, the ECB advised banks under its supervision to assign a greater weight to long-term forecasts based on historical information when estimating future expected losses, and to take into account relief measures such as public guarantees and payment moratoria. Furthermore, it encouraged banks to fully implement IFRS 9 transitional arrangements, whereby they would be allowed to add back a given amount of the increase in provisions as common equity capital. In this manner, the additional provisions made by the computation of expected credit losses would not reduce the banks' regulatory capital.

More importantly, in early April, the Basel Committee decided to allow jurisdictions to reset and extend transitional arrangements in place so that banks could add back to common equity capital up to 100% of new provisions during 2020 and 2021, to be phased-out linearly over the subsequent three years

(BCBS, 2020). This decision was then integrated in the European Commission amendment of the Capital Requirements Regulation (European Commission, 2020).

To complement all these measures, banks were required to cancel dividend distributions and share buy backs until October 2020, with the recommendation later extended until the end of the year (ECB, 2020c, 2020e). This capital conservation measure intended to dissuade banks from using dividend payouts as a signal of strength, which could offset the relaxation of capital buffer requirements, while avoiding the stigma associated to these cancellations.

7. AN ASSESSMENT OF THE REGULATORY RESPONSE TO THE CRISIS

The EU regulatory response to the coronavirus crisis can be described as extremely bold, given the huge size and broad nature of the measures, and extremely fast, given that they were quickly implemented in the early stages of the crisis. Both the boldness and the speed are to be commended.

According to the ECB, the estimated impact of the microprudential measures would amount to a release of €120 billion worth of capital, or to approximately €1.8 trillion in potential new lending (ECB, 2020b). However, there was disappointment at the fact that this lending capacity was not being fully taken up by banks. As noted by Andrea Enria in June 2020: "There is still some apparent reluctance from the bank side to actually use the capital and liquidity buffers," adding that "the liquidity buffers actually increased so far" (ECB, 2020d). Why have banks not drawn down their buffers? Answering this question would require a detailed empirical analysis that is beyond the scope of this briefing paper. However, we could advance a few hypotheses.

On the demand side, there has been a higher demand for credit by firms to cover liquidity needs brought about by the lockdown measures adopted by most countries, but a lower demand for investment by households and firms due to the increased uncertainty about the length and the structural implications of the crisis.

On the supply side, financial market pressure to maintain regulatory capital ratios can constraint buffer usability; see Andreeva et al. (2020). Also, banks may have been reluctant to extend loans that may end up being non-performing.[2] This prudent behaviour may have been socially beneficial given the size of the public guarantees implemented by governments. From this perspective, banks are in fact acting on behalf of taxpayers that will end up covering a significant fraction of future defaults. Finally, the uncertainty about the horizon over which banks will have to replenish their buffers may have reinforced the cautious behaviour of banks; see ECB (2020e).

As for the increase in liquidity buffers, the result is not surprising at all. The counterpart of the huge long-term refinancing operations and asset purchases undertaken by the ECB is an increase in bank reserves that improve the liquidity position of banks.

Perhaps the most remarkable thing about the regulatory response is that, due to the very limited size of the macroprudential buffers, almost all of the adjustment was done through the microprudential measures. Thus, the microprudential authorities adopted a macroprudential perspective. This outcome could be explained by the fact that the Single Supervisory Mechanism is located at the ECB, so the microprudential supervisors are not institutionally separated from the monetary policy makers.

[2] As pointed out by Andrea Enria in the Finanacial Times of 27 October 2020, "we cannot rule out a weak recovery with a significant build-up of bad loans."

The flip side is that the reduction in capital buffers in the context of a much riskier environment will decrease the solvency of banks, which in an adverse scenario may open up the possibility of significant defaults. Hence, it is important to recognize that there is a trade-off: more lending to support the real economy may come at the expense of greater risk for the banking system; see Repullo and Suarez (2012). From this perspective, the recent decision of the European Banking Authority (EBA) to carry out the EU-wide stress tests in 2021 should be welcome (EBA, 2020a).

Finally, given the uncertainty about the impact of the coronavirus crisis on banks' solvency, the decision to cancel dividend distributions and share buy backs was fully justified. Obviously, some banks were in a position to keep paying dividends, but this would probably lead to less solvent banks to do the same, to signal their strength to the market, which would reduce the overall solvency of the banking system. Still, it is the case that banks have voiced opposition to this restriction,[3] probably because of a widespread perception that dividends, not profitability and earnings, is what matters for stock market valuations.

8. LESSONS FOR COUNTERCYCLICAL REGULATION

EU banks entered the coronavirus crisis with high capital and liquidity buffers resulting from the regulatory reforms undertaken after the global financial crisis of 2007-2009. This allowed a bold and swift response by supervisors oriented towards supporting banks' ability to provide credit to the real economy. At the same time, this response made it clear that the contribution of the macroprudential tools was very limited so all the heavy lifting was done by the microprudential supervisors.

The main lessons that can be learned from this experience are the following. First, the macroprudential tools in the current banking regulation are clearly insufficient to deal with large macroeconomic shocks. Second, the new framework for provisioning based on expected credit losses adds an additional layer of procyclicality to the one derived from the risk-sensitive bank capital regulation. Third, given the overall procyclicality of the regulation, an institutional design in which microprudential supervision is close to the central bank is highly desirable, so that microprudential tools can be quickly deployed for macroprudential purposes.

Following from this assessment one can suggest a few policy recommendations.

1. The credit-to-GDP gap should be abandoned as the reference point for the countercyclical capital buffer, because it tends to give wrong signals: loosen in good times and tighten in bad times. Moreover, given that there is no good single indicator of systemic risk, no other single variable should replace it. Instead, macroprudential authorities should use solid macro-financial analysis and sound judgement as the basis for setting the buffer, taking seriously into account original G20 mandate: "Build buffers in good times that can be drawn down when conditions deteriorate." The general perception that cyclical buffers were too small in the wake of the coronavirus crisis should avoid the risk that macroprudential authorities might be too soft in their decisions concerning the CCyB going forward.
2. Banking regulation should be rebalanced to increase macroprudential buffers. As noted by Luis de Guindos, Vice-President of the European Central Bank, "Looking ahead, while the overall level of bank capital is broadly adequate, its composition may be limiting the full potential of releasable buffers as a macro-financial stabilisation tool" (de Guindos, 2020). One concrete proposal would be to raise the upper bound of the CCyB from 2.5% to 4%, and to partially compensate for this increase

[3] See, for example, the article in the Wall Street Journal of 19 October 2020 entitled "European banks await green light for cash dividend payments."

by reducing the CCB from 2.5% to 2%. Thus, there would be a net increase in the maximum value of the sum of the two buffers, from 5% to 6%, but note that this would only apply in boom times. At any rate, the final decision should be made after a careful assessment of the balance of structural and cyclical buffers that incorporates the experience of the coronavirus crisis.

3. It would be desirable to use a single statistical framework in the calculation of the through-the-cycle (TTC) risk measures used to compute capital requirements and the point-in-time (PIT) measures used to compute loan loss provisions. Since PIT measures are conceptually easier, because they rely on the information available at a point in time without any adjustment for business cycle effects, the effort should be placed on clarifying and simplifying the methodology of TTC risk measures. This would save valuable resources in both the supervisory authorities and the supervised entities.

4. Finally, to mitigate the procyclical effects of the new accounting standards (IFRS 9), it would be worth considering expanding the current prudential filters that separate accounting from regulatory capital. In particular, banks that use internal models compute regulatory expected losses over a one-year horizon using TTC risk measures. When accounting provisions exceed regulatory expected losses, the difference may be added to Tier 2 capital up to an upper bound of 0.6% of credit risk-weighted assets. These prudential filters were included in Basel III when the prevailing provisioning requirements were not based on the notion of expected credit losses. Thus, increasing the upper bound and allowing a significant part of the excess to count as Tier 1 capital would reduce the potential excessive impact of the arrival of a recession on banks' lending capacity under the new provisioning requirements.

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EU banks entered the coronavirus crisis with high capital and liquidity buffers resulting from the reforms undertaken after the global financial crisis of 2007-2009. This allowed a bold and swift response by supervisors oriented towards supporting banks' ability to provide credit to the real economy. This paper provides an overview and an assessment of the regulatory response to the crisis, and suggests some recommendations for the future design of countercyclical regulation.

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