Don't let up

The EU needs to maintain high standards for its banking sector as the European economy emerges from the Covid-19 pandemic

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Rebecca CHRISTIE
Monika GRZEGORCZYK
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Abstract

The European banking system has weathered the pandemic reasonably well with the help of government intervention and economic support. Going forward, the EU should ensure the financial sector remains resilient by implementing the Basel III capital requirements in full, monitoring effects of the digital transition, and continuing to hold banks to high standards.

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# LIST OF ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
<th>Description</th>
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<tbody>
<tr>
<td>BCBS</td>
<td>Basel Committee on Banking Supervision</td>
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<tr>
<td>BIS</td>
<td>Bank for International Settlements</td>
<td></td>
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<tr>
<td>CRD</td>
<td>Capital Requirements Directive</td>
<td></td>
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<tr>
<td>CRR</td>
<td>Capital Requirements Regulation</td>
<td></td>
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<tr>
<td>EBA</td>
<td>European Banking Authority</td>
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<td>EBF</td>
<td>European Banking Federation</td>
<td></td>
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<tr>
<td>ECB</td>
<td>European Central Bank</td>
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<tr>
<td>ESRB</td>
<td>European Systemic Risk Board</td>
<td></td>
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<tr>
<td>EU</td>
<td>European Union</td>
<td></td>
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<tr>
<td>FSB</td>
<td>Financial Stability Board</td>
<td></td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
<td></td>
</tr>
<tr>
<td>IFC</td>
<td>International Finance Corporation</td>
<td></td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
<td></td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Cooperation and Development</td>
<td></td>
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<tr>
<td>PEPP</td>
<td>Pandemic Emergency Purchase Programme</td>
<td></td>
</tr>
<tr>
<td>ROE</td>
<td>Return on equity</td>
<td></td>
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<tr>
<td>SSM</td>
<td>Single Supervisory Mechanism</td>
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</tr>
</tbody>
</table>
LIST OF FIGURES

Figure 1: Real GDP growth, euro area 11
Figure 2: Economic growth by sector in 2009, 2013 and 2020 (EU 27) 12
Figure 3: EU employment trends 13
Figure 4: Return on equity of European domestic banks (in % left-hand scale, quarterly) 14
Figure 5: Return on Equity (%) by country 15
Figure 6: Non-performing loans (% of total gross loans) 16
Figure 7: Leverage ratio (fully phased-in definition of Tier 1) 17
Figure 8: Asset quality for selected countries: assets at fair value (% of total assets) 18
Figure 9: Loan coverage ratio 2014-2021 20
Figure 10: Individuals using the Internet for banking (% change y-o-y) 24
Figure 11: Individuals using the Internet for banking (% of individuals) 25
Figure 12: OECD financial literacy scores in the EU 26
Figure 13: Individuals who have a basic or above the basic level of digital skills (percentage of individuals, 2019) 26

LIST OF TABLES

Table 1: Main banking indicators 19
EXECUTIVE SUMMARY

The financial sector is emerging from the shock of the Covid-19 pandemic without having endured a corresponding financial crisis, due to a mix of government intervention and a more resilient starting point because of the regulatory and risk-management improvements enacted after the 2008 global financial crisis and subsequent euro-area sovereign debt crisis. The EU now should continue to hold the banks to high standards, particularly when it comes to capital requirements and other risk-management practices, to avoid future problems. While there have been structural changes, particularly in the area of online services, the pandemic has most notably not changed the underlying challenges facing the sector and should not be used to justify further delays in living up to globally agreed minimum capital requirements.

To achieve these goals, the EU needs to implement the final stage of the Basel III capital standards as agreed globally, rather than yield to bank pressures to create a custom solution that retreats from the core goals of the new framework. The EU has deviated from the Basel standards in the past, which it has said was necessary to account for regional differences and local considerations. It now needs to hew more closely to the international framework to show that it will comply with the core goals of the global standards.

Non-performing loan levels are so far contained and have been consistently managed in recent years. As the pandemic recedes and governments phase out the supports put in place during the height of the downturn, bad loans may rise. So far there are no signs that forthcoming repayment problems will rise to crisis levels, but regulators and financial institutions will need to monitor the situation and act as needed.

The shift to online services has been a key element of the financial sector’s relative strength during the pandemic. To make sure these trends continue to help banks and their customers, without creating new problems, stakeholders will need to promote financial literacy and make sure vulnerable populations are not being left behind. We recommend that governments step up their efforts to track community need through surveys and consultations; that financial literacy be a more consistent part of standard education and offerings to workers and retirees; and that banking consolidation be pursued in ways that support local communities and focus on usable resources rather than protecting sheer numbers of physical offices and financial institutions.
The Covid-19 pandemic has reshaped the global economy dramatically since early 2020, causing shutdowns around the world and upending the economy. Thanks to technology, capital markets and forceful government intervention, the European Union has been able to keep going through the crisis and stave off widespread economic disruption. The pandemic did not trigger a corresponding banking crisis, and banks are holding up despite the ongoing challenges of negative interest rates and lower profitability. A combination of fiscal stimulus and central bank backstops have kept the EU going and laid the framework for a recovery as the public health outlook improves.

The banking system has been one of the most important private-sector elements in maintaining this equilibrium. Europe is more dependent on bank loans than the U.S., which has stronger capital markets, meaning that financial institutions are especially inseparable from overall economic health. The global financial crisis and accompanying euro-area sovereign debt crisis showed the danger of allowing banks too much leeway, particularly when their prospects were intertwined with the health of their home countries. Fortunately, the supervisory and risk-management changes brought about by those events meant EU banks were much more prepared for this crisis than they were for the previous round of shocks. In particular, the start of the euro area's banking union has strengthened oversight of the euro area's biggest banks and laid a foundation for stronger overall financial health.

We see two main challenges for the EU banking system going forward: maintaining high risk-management practices and ensuring that banking technology is available to all who need it. The EU must resist temptations to water down international capital requirements or otherwise allow banks to retreat from the stepped-up buffers that have been required of them in recent years. Right now, the banking sector is not on the brink of crisis. Regulators need to maintain high standards, not offer new waivers or subsidies. The pandemic has not altered the fundamental challenges and risks facing the financial sector and complying with international agreements should remain the EU's top regulatory priority. Also, in order to make sure the benefits of a stronger economy reach the general public, financial firms and regulators need to make sure that digital banking services are available throughout the economy, not just to certain privileged sectors.

We therefore recommend the following measures:

**KEY FINDINGS**

The Covid-19 pandemic has not triggered a corresponding financial crisis, thanks to government intervention, central bank supports and bank-sector strengthening enacted after the 2008 global financial crisis and subsequent euro-area sovereign debt crisis. The EU needs to stay the course on banking regulation to avoid future shocks.

The EU now should implement the latest Basel III capital standards fully and monitor non-performing loan levels. The need for these measures has not changed due to the Covid crisis, and no new trends have emerged that would justify changing course.

The EU also should take care to ensure digital banking opportunities are available to all who need them so that the financial sector can play its role in the recovery. In this area, the pandemic has accelerated the digital transition in many countries, and policymakers need to ensure vulnerable populations are not left out. We recommend policymakers improve internet access, technological accessibility and financial literacy in order to keep banking services widely accessible.
• The EU needs to implement the Basel III capital standards as agreed globally, rather than yield to bank pressures to create a custom solution that retreats from the core goals of the new framework.

• Regulators need to monitor non-performing loans, which so far have remained at manageable levels, to make sure that the financial sector does not lose its ability to lend as pandemic supports are withdrawn and some firms do not survive the pandemic.

• Industry and government need to work together to make sure digital banking is widely available through the economy, that financial technology innovation can continue, and that risk management practices do not suffer as a result of the shift to digital services.
2. POST-PANDEMIC ECONOMIC OUTLOOK

Economic growth fell sharply in the euro area and across the EU in 2020 due to the shutdowns and disruptions caused by the Covid-19 pandemic. Growth rebounded in 2021 and is expected to continue in 2022, according to International Monetary Fund (IMF) estimates.

Figure 1: Real GDP growth, euro area

The financial-services sector was not hit nearly as hard as other parts of the economy by the 2020 disruptions, according to data from the OECD. We can also see that financial services fared better than many industries during prior economic shocks. A snapshot of 2009, in the middle of the global financial crisis, and 2013 during the euro-area sovereign debt crisis shows that banks were hanging on and in some cases recovering. This pattern of resilience reinforces current expectations that a financial crisis will not be forthcoming.
Looking at the broader economy, we also see that unemployment fell in the early stages of the pandemic and then recovered as companies and workers adjusted to telework, furlough conditions and government support options. These patterns hold at the country level, suggesting that labour markets will support forecasts for ongoing growth in 2022. In terms of consumer demand, the pandemic led to more investment in housing and real estate as workers and families sought out more space and more workable home offices. This in turn led to more purchases of furnishings, durable goods such as appliances, gaming and exercise equipment (Madgavkar and Remes, 2021).
While the recovery is underway, we do see continued risks from new public health threats and from the uneven nature of post-pandemic growth. For example, the tourism sector remains troubled, due to ongoing travel restrictions and other constraints, prolonging difficulties for the accommodation and transport sectors. A switch to online meetings rather than in-person gatherings and conferences has further restrained business travel, previously a strong source of income for those industries, and those changes may remain well into the future. Globally, shipping and energy-price uncertainty continue to threaten the global supply chain. Consumers have embraced online shopping while also beginning to return to in-person stores, but inventory shortfalls and inconsistencies remain problematic.

Because companies face so much uncertainty about the future, they may correspondingly invest less, particularly if they are considered about taking on new loans. García-Herrero A. (2020) suggested that the Covid-19 crisis might put firms on a less profitable trend, creating an incentive to cut investments further, while Revotella (2020) also found firms may want to invest less as they ride out the current conditions. This resistance to taking on new leverage may in turn spill into the financial sector, which is also trying to limit risk and reduce exposure.
3. BANKING INDUSTRY PERFORMANCE

The European banking sector has generally remained healthy even though negative interest rates, in place from the ECB since 2014, have put continuous pressure on banks’ ability to lend and maintain profits. Despite concerns that earnings would suffer, the industry has on the whole stepped up to the challenge.

Return on Equity (ROE) indicators confirm that EU banks stayed profitable in this new environment. Although we can observe that the dispersion around the average ROE was substantial between 2015-2017, signalling fragmentation, it decreased in subsequent years. We can therefore conclude that even if the pandemic has hurt bank earnings, that deviation from the mean is also smaller and returns remain in positive territory.

Despite this general positive trend, banks in countries that were forced to seek euro-area assistance during the previous crisis faced trouble. ROE in Greece, Ireland, Spain, Cyprus and Portugal showed negative values in 2020. Even before the pandemic, ROE at Greek banks was lower than 1%.

Bank profitability certainly remains on the radar. The industry brings it up regularly and supervisors continue to monitor developments closely for signs of systemic risk. The European Systemic Risk Board said in September that the pandemic has exacerbated challenges related to solvency and profitability (ESRB 2021c). That said, a challenge is not the same thing as a concern that should take top priority. Andrea Enria, banking supervision chair for the ECB, said in September that banks can look forward to tangible improvements if they are able to consolidate, pursue mergers where appropriate and make other structural changes over time. EU banks have struggled with profitability well before the crisis, due to factors like having too many branches to be cost-effective and due to the EU’s resistance to closing failing banks. If banks turn their attention to long-term value creation, Enria said the outlook might even be “optimistic”. He also affirmed the commitment to stronger risk management practices: “the regulatory overhaul that followed the great financial crisis rules out strategies boosting leverage and pursuing risk taking as shortcuts to achieving a higher return on equity” (Enria, 2021b). Regulators

Figure 4: Return on equity of European domestic banks (in % left-hand scale, quarterly)

![Figure 4: Return on equity of European domestic banks](source: ECB)

**Figure 4:** Return on equity of European domestic banks (in % left-hand scale, quarterly)
Don’t let up - The EU needs to maintain high standards for its banking sector

therefore do not see profitability concerns as standing in the way of higher capital requirements and other global efforts to strengthen the banking system.

Figure 5: Return on Equity (%) by country

In general, bank balance sheets have increased somewhat, mostly due to an increase in liabilities. This may reflect their use of pandemic support programs such as those designed to stave off a surge in non-performing loans.

IFC (2021) suggests a significant increase in non-performing assets worldwide, a concern given that high volumes of non-performing loans can dent banks profitability by limiting lending and reduce output growth (Balgova et al. 2016). In Europe, we see that systemic risks identified by ESRB (2021b) are putting pressure on the solvency of non-financial corporations as well as on household indebtedness. This means the financial system could be at risk from spillovers as parts of the economy face difficulties repaying maturing debt. Despite those risks however, and despite ongoing concern about lingering from bad loans accrued during the previous round of financial crisis, NPL levels have been contained. Data shows improvement in the number of NPLs in selected countries, even as individual discrepancies remain.

Source: ECB.
Figure 6: Non-performing loans (% of total gross loans)

Source: IMF, Financial Soundness Indicators, Core refers to Austria, Belgium, France, the Netherlands. Germany is not included due to a lack of data availability.

We also see that banks’ liquidity coverage ratio has increased while their loan to deposit ratio is decreasing, measures that put pressure on profitability yet also suggest that banks are not as exposed to loan repayment risks (Table 1). The ECB’s pandemic emergency purchase programme (PEPP), which began in March 2020, was a main reason that loan coverage ratios increased significantly while the loan-to-deposit ratio fell. This is because PEPP pushed liquidity into the banks in hopes of getting more credit into the overall economy – banks are now flush with liquidity and yet have been conservative with their lending strategy in a bid to avoid making new bad loans. We would expect that this conservative approach would continue after the pandemic support programs phase out, leading to lower liquidity but also continued risk aversion.

Between the fourth quarters of 2014 and 2020, gross NPLs in the euro area decreased from €998 billion to €443 billion, according to ECB figures (Enria 2021a). Despite the pandemic, in 2020 the industry continued to work through the resolution of so-called legacy NPLs from prior crises. Enria said that at the end of the first quarter of 2021, the NPL ratio of banks under ECB direct supervision stood at 2.5%, down from approximately 8% at the end of 2014, the year the Single Supervisory Mechanism (SSM) took on its oversight role (Enria 2021b). He said that were it not for the uncertainty of pandemic recovery, he would be "tempted" to say NPLs were no longer a problem for the industry, however the broader economic outlook means it is too soon for supervisors to let down their guard. As of May, pandemic-related deterioration had not yet emerged, and bank profitability rose due to lower provisioning. That said, regulators and market analysts are watching carefully for a surge in NPLs as the pandemic recedes, particularly given the wide range of disruptions, market conditions and government supports that affect loans to various industries.

EU banks traditionally have higher excessive leverage compared to the UK and the US banks. High leverage might result from low interest rates, but leverage ratios might also be improved by ECB support programs (ESRB 2021a). Also, FSB (2021) consider the possibility of debt overhang in the non-financial sector and note that banks with excess liquidity might be afraid to use it to provide more loans to the market, in order to stay well protected against future risks. Even when public support started immediately once the pandemic was underway, some banks took defensive actions to maintain liquidity levels well above regulatory minimum levels.
Leverage ratios show how banks finance themselves and are particularly useful in assessing bank performance compared to past results and those of their peer institutions. Generally, banks have improved on that measure as well – even for banks in countries that were the most troubled after the global financial crisis, the leverage ratio has converged toward the EU average, using the Basel III capital definitions now being phased in.

Figure 7: Leverage ratio (fully phased-in definition of Tier 1)

Source: ECB. Core refers to Austria, Belgium, Germany, France, the Netherlands.

ECB estimates suggest that full implementation of Basel III would increase the leverage ratio by around 0.6% (Budnik et al. 2021). As a result, banks would have lower debt-funding costs and presumably a corresponding increase in profitability.

Asset quality is a particular concern for smaller banks, already squeezed by overcrowded banking markets and poor efficiency (ECB 2020). However, at the start of the pandemic these banks had relatively few bad loans on average – only 2.3% of total loans –, ample liquidity buffers that were on average double the required minimum and a good solvency position, with Common Equity Tier 1 capital standing at about 17%, well above minimum requirements. Asset quality in various countries has generally held up, and in some cases even risen, during the course of the pandemic. This too is connected with the ECB’s purchase program, as well as with more conservative banking practices in general that may have, on the negative side, curtailed liquidity available to the general economy.
Table 1 shows further developments in the evolution of EU banking indicators over the course of the pandemic. In particular, we see that loan coverage ratios, indicating the proportion of non-performing loans that are covered by reserves, have declined somewhat, but not dramatically, during the pandemic. Table 1 shows that the coverage ratio is less than 50% and deteriorated slightly in the euro area, making them more vulnerable to adverse shocks.
Table 1: Main banking indicators

<table>
<thead>
<tr>
<th></th>
<th>2019Q1</th>
<th>2019Q2</th>
<th>2019Q3</th>
<th>2019Q4</th>
<th>2020Q1</th>
<th>2020Q2</th>
<th>2020Q3</th>
<th>2020Q4</th>
<th>2021Q1</th>
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<tr>
<td>Total assets (EUR billions)</td>
<td>22695.57</td>
<td>22650.62</td>
<td>23262.85</td>
<td>22184.67</td>
<td>23991.82</td>
<td>24430.69</td>
<td>24357.08</td>
<td>24193.2</td>
<td>25218.12</td>
</tr>
<tr>
<td>Total equity (EUR billions)</td>
<td>1511.446</td>
<td>1489.525</td>
<td>1519.501</td>
<td>1531.983</td>
<td>1523.509</td>
<td>1516.005</td>
<td>1521.222</td>
<td>1533.812</td>
<td>1562.953</td>
</tr>
<tr>
<td>Total liabilities (EUR billions)</td>
<td>21184.12</td>
<td>21161.1</td>
<td>21743.35</td>
<td>20652.69</td>
<td>22468.31</td>
<td>22914.68</td>
<td>22835.86</td>
<td>22659.39</td>
<td>23655.17</td>
</tr>
<tr>
<td>ROE</td>
<td>5.76%</td>
<td>6.01%</td>
<td>5.83%</td>
<td>5.16%</td>
<td>1.21%</td>
<td>0.01%</td>
<td>2.12%</td>
<td>1.53%</td>
<td>7.21%</td>
</tr>
<tr>
<td>Cost-to-Income ratio</td>
<td>69.18%</td>
<td>66.43%</td>
<td>65.48%</td>
<td>65.84%</td>
<td>72.44%</td>
<td>67.61%</td>
<td>65.50%</td>
<td>66.03%</td>
<td>64.69%</td>
</tr>
<tr>
<td>Cost of risk</td>
<td>0.75%</td>
<td>0.52%</td>
<td>0.47%</td>
<td>0.5%</td>
<td>0.66%</td>
<td>0.70%</td>
<td>0.64%</td>
<td>0.67%</td>
<td>0.64%</td>
</tr>
<tr>
<td>Tier 1 Ratio [%]</td>
<td>15.60%</td>
<td>15.55%</td>
<td>15.58%</td>
<td>16.13%</td>
<td>15.64%</td>
<td>16.13%</td>
<td>16.50%</td>
<td>16.98%</td>
<td>16.77%</td>
</tr>
<tr>
<td>Common Equity Tier 1 Ratio [%]</td>
<td>14.35%</td>
<td>14.33%</td>
<td>14.37%</td>
<td>14.94%</td>
<td>14.42%</td>
<td>14.89%</td>
<td>15.20%</td>
<td>15.65%</td>
<td>15.49%</td>
</tr>
<tr>
<td>Leverage Ratio (Fully Phased-In definition of Tier 1)</td>
<td>5.23%</td>
<td>5.24%</td>
<td>5.26%</td>
<td>5.59%</td>
<td>5.23%</td>
<td>5.16%</td>
<td>5.46%</td>
<td>5.83%</td>
<td>5.56%</td>
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<tr>
<td>Leverage Ratio (Transitional definition of Tier 1)</td>
<td>5.41%</td>
<td>5.42%</td>
<td>5.42%</td>
<td>5.74%</td>
<td>5.36%</td>
<td>5.33%</td>
<td>5.63%</td>
<td>6.01%</td>
<td>5.70%</td>
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<tr>
<td>NPL Ratio</td>
<td>3.68%</td>
<td>3.56%</td>
<td>3.41%</td>
<td>3.22%</td>
<td>3.05%</td>
<td>2.94%</td>
<td>2.82%</td>
<td>2.63%</td>
<td>2.54%</td>
</tr>
<tr>
<td>Level 1 as a share of total assets</td>
<td>7.74%</td>
<td>7.71%</td>
<td>7.45%</td>
<td>7.15%</td>
<td>6.97%</td>
<td>7.24%</td>
<td>7.08%</td>
<td>6.77%</td>
<td>7.14%</td>
</tr>
<tr>
<td>Level 2 as a share of total assets</td>
<td>13.03%</td>
<td>14.01%</td>
<td>15.3%</td>
<td>13.02%</td>
<td>15.42%</td>
<td>13.90%</td>
<td>13.65%</td>
<td>13.47%</td>
<td>13.01%</td>
</tr>
<tr>
<td>Level 3 as a share of total assets</td>
<td>0.84%</td>
<td>0.86%</td>
<td>0.87%</td>
<td>0.89%</td>
<td>0.96%</td>
<td>0.87%</td>
<td>0.82%</td>
<td>0.81%</td>
<td>0.82%</td>
</tr>
<tr>
<td>Coverage ratio</td>
<td>48.25%</td>
<td>47.97%</td>
<td>47.64%</td>
<td>47.56%</td>
<td>47.79%</td>
<td>47.14%</td>
<td>47.15%</td>
<td>46.82%</td>
<td>46.58%</td>
</tr>
<tr>
<td>Liquidity coverage ratio</td>
<td>148.96%</td>
<td>146.7%</td>
<td>145.06%</td>
<td>145.93%</td>
<td>146.47%</td>
<td>165.41%</td>
<td>170.83%</td>
<td>171.68%</td>
<td>172.73%</td>
</tr>
<tr>
<td>Loan-to-deposit ratio</td>
<td>118.03%</td>
<td>116.98%</td>
<td>116.78%</td>
<td>116%</td>
<td>116.04%</td>
<td>110.81%</td>
<td>108.32%</td>
<td>106.72%</td>
<td>106.07%</td>
</tr>
</tbody>
</table>

Source: ECB.

If we look at the loan coverage ratio specifically, we can see that it has been higher through the Covid-19 pandemic than prior to 2017, suggesting that banks have been buoyed through a combination of fewer non-performing loans after the euro crisis; higher buffers; and more recently government guarantees. Anderson, Papadia and Véron (2020) find that that the guaranteed funds seem to be working as liquidity buffers. Additionally, country differences in credit-support programmes do not appear to have caused single market fragmentation. It thus seems that potentially harmful procyclicality has been
effectively mitigated in that area, as mass bankruptcies appear unlikely, and banks seem well prepared to handle the levels expected. If bankruptcies do emerge on a greater than expected scale, we would expect the government guarantees to provide sufficient buffers to prevent a financial-system shock.

Figure 9: Loan coverage ratio 2014-2021

Source: ECB.
4. DEBATE OVER UPDATES TO BASEL III REQUIREMENTS

International regulators in 2017 agreed on the Basel III reforms in response to the 2007-10 global financial crisis, after eight years of talks on the best way to protect the worldwide financial system from future shocks. The framework represents the finalization of the Basel III process, after an initial set of changes that raised capital requirements, strengthened the quality of loss-absorbing capital for viable banks, and added macroprudential requirements. (Bank for International Settlements 2017). Due to the COVID-19 pandemic, implementation of the final form of the new framework was postponed; it is now expected to come into effect by 1 January 2023. The European Commission is preparing legislation to enact the new reforms and is balancing the requirements of the global framework alongside the EU banking sector’s specificities. In particular, European banking industry leaders have called for the EU to diverge from Basel III when it comes to the “output floor,” which limits the amount of capital relief that banks can gain from using internal risk-management models.

The EU is the only jurisdiction that has so far been non-compliant with the Basel III changes already in place, according to Basel Committee review. This conclusion was reached in an assessment of those nine member states that were members at the time in the context of the EU’s Capital Requirements Directive IV (CRD IV) and Capital Requirements Regulation (CRR), which came into force at the start of 2014. After Brexit, the EU’s Basel committee members are Belgium, France, Germany, Italy, Luxembourg, the Netherlands, Spain and Sweden. (Basel Committee on Banking Supervision 2014). Specifically, the EU members were found to have diverged from the global standards in areas such as counterparty credit risk, preferential treatment for some mortgage loans, and permanent partial-use exemptions for various type of credit risk exposures. The committee further singled out the EU’s decision to extend concessionary risk weights to small- and medium-sized enterprise exposures for customers in the EU and outside it, "an important departure from the letter and the spirit of the Basel minimum requirements." It is striking for the EU to be in such a catch-up position given its broader efforts to take on a global leadership role and be a first mover in areas such as climate, data protection and competition policy. The goal of the Basel III finalization package is to reduce areas of divergence. In particular, EU attention specificities on elements like how to classify mortgage loans may remain in place while the EU seeks to adopt fully the new core requirements on capital standards.

Broadly speaking, the Basel Committee wants banks to use an output floor to ensure they do not fall below a certain percentage of capital requirements, as laid out under the standardised approaches (BIS 2017). Likewise, the EU aims to implement the Basel III updates without requiring dramatic capital increases from the industry as a whole, even though some banks will need to add risk buffers if they do not meet the new requirements.

European central banks and regulators have urged the Commission to hew as closely to the international agreement as possible when implementing the next round of changes. In particular, the EU needs to resist calls to allow banks to use a so-called “parallel stack” approach that would create multiple types of capital standards within individual banks, the European Central Bank and European Banking Authority warned September (EBA and ECB, 2021). Such an approach would diverge significantly from the international standards and jeopardize regulators’ ability to curb risk-taking and ensure banks are well-protected. A coordinated letter from 25 financial supervisors and central banks concurred, arguing that the buffers as proposed are simple and transparent, preserve a level playing field between banks that use internal models and those that use a standardized approach, and among banks worldwide that use a variety of risk-management models (National Bank of Belgium et al, 2021).

The parallel stacks approach, which the banking industry says is necessary to avoid “excessive” capital increases, would apply the output floor separately from the latest Basel framework updates. It would
thus use the capital standards set out in the initial Basel III rules, rather than the ones in the final version, which the Basel Committee says are specifically designed to limit the use of internal models and introduce a more "robust, risk-sensitive" floor based on stronger standardised approaches. The European Banking Federation defended the parallel stack proposal in June, arguing that it is compliant with the international accords and would reduce the impact of the new framework on loans to unrated European companies, who are not globally active yet provide crucial support to the EU economy (EBF 2021).

The regulators and central banks counter that EU banks must not be allowed to weaken capital standards or introduce more risk-management variability. Full implementation of Basel III is "essential to ensure banks can withstand future crises and a necessary condition for the proper functioning of the European and global financial systems," according to the ECB and EBA. The EU's prior deviations from the Basel standards have been based on regional conditions, but the output floor debate affects the core of the reforms and compliance will need to be held to a higher standard.

Bringing Basel III to Europe in full would have only modest transitional cost while bringing considerable long-term benefits, according to an ECB analysis. Research by Budnik et al. (2021) shows that implementing Basel III regulations may reduce lending to non-financial corporations, and therefore economic growth in the short term. In the first four years after the new rules are introduced, output as measured by GDP would be reduced by an estimated at 0.2% annually. At the same time, however, Basel III implementation would improve the banking sector’s resilience through higher capital stock, leading to lower bank funding costs. It would also make the system safer: loss-absorption capacity would increase by 15%.
5. **FINANCIAL TECHNOLOGY AND DIGITAL INCLUSION**

The move to online services has been a crucial part of withstanding the pandemic, to the point where considering overall banking system health without acknowledging the digital transition would only paint half of a picture. The connections permeate both the economy and the Covid-19 response at all levels. To give one example, the European Commission’s Resilience and Recovery Facility, which prioritises the green and digital transitions in the support it offers to member states. Because of these fiscal priorities, further digitalisation might significantly contribute to EU growth.

Economic research suggests that such fiscal stimulus can take the form of a positive investment shock, by supporting consumption and also preventing drops in output. (Smets and Wouters 2003). Similarly, a positive productivity shock, rooted in technological improvements, leads to a gradual increase in production, consumption, and investment. This suggests that supports aimed specifically at technological and environmentally oriented changes have the possibility to contribute to growth and economic recovery, as well as stronger performance in those specific areas. Banks will be affected by these changes both in terms of how they manage their own operations and in terms of which sectors seek and receive new financing.

The pandemic accelerated shifts in business preferences towards more digital services. LaBerge et al. (2020) estimate that in Europe, the pandemic accelerated the digitalisation of customer interactions by around three years and digitalisation of services and products by seven years. Madgavkar and Remes (2021) find that remote work allows companies to have more choice of workers due to decreased reliance on physical distance to the office, while saving money on in-office expenses. Many workers have been able to improve productivity thanks to lower commuting requirements, and companies may have been able to make more use of automation and other technologies so that they put their human workforce to best use.

Looking more broadly, we see the pandemic leading to changes in consumer savings habits, a rethinking of how best to use the global supply chain, and an increased focus on the role of government in providing economic supports (Revoltella 2021). The pandemic itself may not be a direct cause of decarbonization, other than by reducing air travel for a few years, but the investments sparked by public fiscal stimulus programs have the potential to reshape the economy in years to come. Banks will be part of this process, as they provide more support to sectors that are leaders in the digital and green transitions and rethink their exposure to legacy industries.

Sectorial analysis shows that the increases are not evenly distributed, with the most substantial growth in healthcare, pharma, financial services, and professional services. Grömling M. (2021) note that COVID-19 led greater technology acceptance in general, among other behavioral changes, as companies and governments extended remote services to all manner of professional and educational settings. These changes may lead to permanent structural shifts in how the economy works. Accordingly, regulators will want to make sure traditional banks and new entrants to the market are licensed and regulated appropriately.

A survey by Maqui E. and Morris R. (2020) shows that remote work and acceleration of digitalisation are the main long-term effects of the pandemic reported by leading companies: 90% of respondents agreed that the pandemic has caused to accelerate the take-up of digital technologies, and digital finance was among the most urgent perceived needs.

Digitalisation of financial services is associated with the developments in financial technology industries (FinTech), but comprehensive data on FinTech have historically been scant (Cortina and Schmukler 2018). That may be due to the very different types of services provided within the industry...
as well as the difficulty of classifying innovations. Non-bank lenders, often either peer to peer or through a marketplace, provide loans mainly to individuals and small and medium-sized enterprises (SMEs). They do not have branches, offer mainly short-term loans, and their service can be faster than going through traditional banks.

Saka et al. (2021) show an increase in digital transactions due to the pandemic, even as general banking activity volumes stayed steady, due to more and more operations moving online. This raises concerns about inequality levels, which intensified during the pandemic. After all, Internet access is crucial for making the switch to using more financial technology services, for households and small businesses alike. That said, big firms have every incentive to encourage shifts to digital services in hopes of improving efficiency and reducing the need to spend money on offering in-person services.

Ben-David et al. (2021) find that as demand for small-business credit increased, the applicants for loans became more creditworthy, but loan supply collapsed as FinTech lenders who were financially constrained lost ability to fund new loans. The World Economic Forum (2020) suggests that the impact of the pandemic on FinTech sectors was uneven, with the most severe impact on digital lending. WEF recommended accelerating authorisation and licensing process for new activities, which in turn might improve access to government supports, subsidies and tax breaks.

In most EU countries, adoption of online banking services has grown much faster in the last year than in the previous decade (Figure 10).

Figure 10: Individuals using the Internet for banking (% change y-o-y)

There are some countries, like Estonia or Luxemburg, where the rate in 2020 did not increase, because online banking was already in widespread use. Internet banking adoption rates are not equal in all EU countries: In Estonia and Luxemburg exceeded a 70% rate of people who are using the Internet already in 2019. Countries like Romania and Bulgaria advanced their banking services significantly in 2020. However, Figure 4 shows that the percentage of individuals who used internet banking in 2020 in Romania was 12% and Bulgaria 13%, the lowest in the EU and more than four times below the EU average (58%).
Low digital uptake in some EU countries creates a challenge for financial inclusion. Thus, regulators might consider guidelines for commercial banks to make online banking more accessible, so that the shift to digital banking leaves fewer people behind.

Financial literacy will be an important prerequisite for using the new technology and adjusting to changes in what services can be done in person, on the phone or on paper. Areas with low financial literacy also tend to be those with higher levels of poverty, social mobility and economic inequality (Demertzis 2018). Within the EU, however, financial literacy is relatively high in most member states.

The financial education company EVERFI (2021), found that banks need to pay more attention to the many reasons financial literacy will help not only consumers, but the banks’ bottom line. For example, consumers who feel comfortable making financial decisions by themselves are also more comfortable using self-service options like kiosks and online services, reducing demands on banking staff. Increased use of digitalization also allows banks to tailor their offerings more specifically to consumers. If these consumers are not comfortable managing the complexity that comes along with this kind of decision-making, they are more likely to make mistakes that hurt both them and their bank. But if financial institutions can set their customers up to succeed, both groups can benefit and create a virtuous cycle of further opportunity.

Looking specifically at Belgium, ING (2021) found that financial illiteracy is a “hidden” problem. For example, more than 20% of households do not have any members who are able to manage online banking transactions or use a credit or debit card. Many students, not just in Belgium but across Europe, are uncomfortable with even basic spending and financial decision-making. Banks thus need to step up consumer outreach to protect their own customer base.
Some people may still find digital financial services hard to access, due to poor internet access or general computer literacy. Especially, older adults might struggle more. As shown in Figure 13, the people with the lowest percentage of basic or above basic digital skills are older adults. Also, the discrepancy between the countries with the highest rate in this age group (the Netherlands) is more than six times higher than those lagging in digital skills (Bulgaria, Romania). In an OECD (2020) survey, 50% of financial consumer protection authorities indicate low digital capability, low financial literacy, cognitive decline, physical decline as the main factors of exclusion among older populations.

Research by Marston H. et al. (2019) shows that one of the factors working against digital adaptation might be fear of using new technologies. Focus on overcoming the negative perception and barriers of information and communications technologies among older adults therefore should be included in the financial technology transition of the banks, alongside peer-to-peer learning and support offerings.

Figure 12: OECD financial literacy scores in the EU

Figure 13: Individuals who have a basic or above the basic level of digital skills (percentage of individuals, 2019)
In light of these changes, we would recommend that governments increase their efforts to track developments so that policy can respond accordingly. Surveying this behavior is difficult but worth the effort, and policymakers should not shy away from the challenge.

Financial literacy will be essential for community members to use and understand banking services available to them, and we would recommend such outreach be available within standard education for young people as well as extended to adults in the workforce or retirement. To further this goal, we would urge banks to take a consumer-centric approach to designing and distributing financial products.

Regarding the banking sector in particular, we know that banking consolidation and branch restructuring is needed for the industry to set itself on the best footing (Enria 2021b). To offset the impact of this on vulnerable communities, the OECD (2020) has suggested more consultations with local groups to help them adapt to these changes and make use of all available alternatives to legacy offerings. We support this recommendation and would further recommend that branch closures be coordinated regionally so that specific areas do not find themselves in feast-or-famine conditions. The effectiveness of the banking sector is a separate question from the sheer quantity of banks and branches in the economy. Both consumers and banks would therefore benefit strongly from a more consolidated and effective financial sector that has access to appropriate resources and technology.
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The European banking system has weathered the pandemic reasonably well with the help of government intervention and economic support. Going forward, the EU should ensure the financial sector remains resilient by implementing the Basel III capital requirements in full, monitoring effects of the digital transition, and continuing to hold banks to high standards.

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