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: a much needed fix

1. Our subject is a very challenging and also a very broad one.
2. I will treat it focusing my attention on the banking sector and its lending activities.
3. I choose this topic for 2 reasons:
   1) first of all, as 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, at the same time, 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 shortcomings in the European banking union regulation.
4. To 1): Policy makers are well aware of the strategic importance of lending in the current economic environment.
5. ECB acted very quickly, providing abundant liquidity to the banks (TLTROIII, the new PELTRO and other important facilities).
6. ECB Banking Supervision authorized a temporarily easing of some requisites (Pillar 2 Guidance, Capital Conservation buffer and LCR).
7. The EP and the European Council provided a quick fix of CRR2, with some useful correction to the previous text.
8. All this is good, but in my opinion is not enough in order to enhance the resilience of European banking system in the coming months.
9. In fact, other measures will be necessary.
10. I mention some of them very briefly:
    - 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, delaying Calendar provisioning by two years (the current provisioning curves for NPLs should be deferred for 24 months),
    - a more substantial delay of the new definition of default (which was delayed… from 31.12.2020 to 1.1.2021).
11. 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

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

capital or at least discourage banks from issuing financing in an economy under strain in order to avoid negative repercussions on capital".[2]

12. The need for a delay in applying rules approved only one year ago can be disturbing.
13. But there is a serious reason for this: these rules are pro-cyclical.
14. To 2): Beyond the current emergency, we can raise some doubts on the philosophy that supported the regulation wave that affected the European banking and financial system after the Great Recession.
15. Let me sum up this philosophy in a few key sentences:
    1) Concentration is the royal road to competition on a global scale
    2) One size fits all.
    3) Strong oversight of credit risk is needed, much less in case of market risk
    4) Derisking is a priority.
16. Just a few words on each of these principles:
17. 1) Concentration as *the* solution to competition issues.
18. As a matter of fact European banking sector underwent a huge concentration process in the last years: in 2013 EU banks were 8,000, in 2019 they were 3,400.[3]
19. (If a comparable process will be repeated now, we could have in 2025 less than 1,500 EU banks. I don't think that such an outcome would be something worth wishing for. Because:)
20. Economies of scale aren't the only competitiveness tool (in the Fintech-era, capital and knowledge are much more important)
21. Furthermore: some economies of scale were actually created by regulation itself.
22. So we come to 2): the One size fits all dogma. (Dimensional bias.)
23. [2a.] If we refuse every proportionality in applying an increasingly complex regulation,
    = if we don't proportionate the compliance costs,
    this will raise costs for little banks above the level at which profitability can be achievable.
24. [2b.] Moreover, the current regulation enables big banks to use less capital than the little ones for the same activities (for instance: covering interest rate risk is for minor banks more costly, due to the impossibility to use internal rating models).
25. In doing so, we are forcing concentration through regulation.
26. I'm well aware that many regulators and supervision entities, in Frankfurt as in many national capitals, think that this is the way for European banking to be competitive at a global level.
27. Such an approach seem to forget that in the Usa a few very big banks coexist with many community banks, that are ruled on the basis of a proportionality principle (= less rules, lower capital standards etc.).
28. The new concept of "small or less-complex entities" introduced in CRR2 could help, but till now only a few regulator benefits are linked to this concept.
29. 3) Strong oversight of credit risk, much less of market risk. (Functional bias)
30. As you may know, in the first 4 years of the new ECB-BS, market risk was never one of the five top priorities for ECB Supervisory activities on European banks, while credit risk was always regarded as a priority.
31. Principle here is: we need less lending by banks, more capital from the capital market.
32. Consequence is: the use of capital for finance is favored, the use of capital for lending is discouraged (Hence the turn of many banks toward a fee based model etc.).

[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.

33. We must be aware that:
34. - today the biggest source of systemic risk for banks in Europe is market risk, not credit risk;[4]
    (for this reason part of the regulation concerning market risk was timely eased once financial turmoil began)
35. – finance can't be the only game in town. We need banks that lend to non-financial firms and families. No CMU can be an adequate substitute for this.
36. 4) My last point is: <u>Derisking as a priority</u>.
37. This was sensible in the aftermath of 2008 etc crisis, and it sounds good.
38. But an important disclaimer is needed:
    through regulation you can control risk, but you can't avoid risk at all.
39. This ingenuous hope 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:
40. all this can have and actually had (as Italy experienced in 2015/2016) pro-cyclical effects on business, setting in motion a vicious mechanism of self-reinforcing processes and self-fulfilling prophecies.
41. <u>Conclusion.</u> 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 (we usually call this last kind of restructuring "revolution").
42. 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.
43. We should take the opportunity to rethink the approach that prevailed in building the European banking union, and to give up the above mentioned dogmas.
44. I think that only if we'll succeed in doing so our banking system will be sound and capable to give its contribution to the necessary economic recovery, instead of becoming part of the problem.

[4] 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.