

Policy Brief

Never waste a good crisis

European banking regulation in the pandemic

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#Banking
#MacroprudentialSpace
#BufferUsability

The regulatory framework for banks introduced in the aftermath of the global financial crisis was designed to provide financial stability in good and bad times. Given an external shock, capital buffers are meant to cushion losses and prevent banks from pro-cyclical deleveraging. However, insufficient accumulation of easily releasable buffers ahead of the pandemic, combined with banks' unwillingness to use the available ones, made European decision-makers tweak hard banking law during the pandemic. While micro-prudential, monetary and fiscal policy measures together proved successful in avoiding a credit crunch, Europe should revisit its macro-prudential framework to ensure full operability in the next crisis.

Introduction

The turmoil caused by the Covid-19 global pandemic has been the first real-life stress test of the banking reforms that followed the global financial crisis. Previously, the regulatory framework had been focused on preventing banks from taking risks that could endanger their own resilience. Based on the experience that this approach had failed to safeguard financial stability 2007-2009, the EU followed the Basel III recommendations and introduced a macro-prudential dimension looking at the financial system as a whole. Since 2016, capital buffers on top of own funds are intended to prevent banks from cutting lending in the event of a crisis since procyclical behaviour would worsen the economic situation.

When the pandemic hit Europe in March 2020, banks were indeed better capitalised than at the onset of the global financial crisis. However, macro-prudential capital buffers had been inadequately built up in most EU countries and banks were unwilling or unable to use existing ones. Concerned about putting the macro-prudential framework to the test, authorities [deployed](#) micro-prudential tools to prevent banks from harmful deleveraging or fire sales. Regulators granted maximum flexibility while supervisors asked banks to suspend dividend payments to shareholders. Last but not least, European lawmakers eased the rules to encourage banks to continue lending.

These efforts, together with public and monetary support, have successfully stabilised the European financial system and many economies are now expanding. However, this policy paper argues that the misalignment of policies calls for improvements of the macro-prudential framework in Europe. Section 1 summarises the micro-prudential measures enacted during the pandemic, in particular the ad hoc amendments to EU banking law (“CRR quick-fix”). Section 2 shows the limited macro-prudential space when the pandemic hit Europe. Section 3 elaborates on the constraints for buffer usability. Section 4 outlines possible ways to restore the operability of the buffer framework.

1 Recourse to micro-prudential measures during the pandemic

When the pandemic hit Europe in spring 2020, EU governments and the European Central Bank (ECB) deployed comprehensive monetary and fiscal support policies. [Macro-prudential authorities](#) relaxed measures and released capital buffers. In addition, banking [regulators](#) and [supervisors](#) granted banks full flexibility in the application of the EU banking framework and provided them with capital and operational relief. To reduce potential market pressure on individual banks and prevent them from unduly eroding their loss-absorbing capital base, the [ECB](#) and the European Banking Authority ([EBA](#)) recommended a blanket dividend suspension for all banks in the EU. Even so, banks claimed they couldn’t withstand the losses from the economic fallout without tweaks to hard EU banking law and [urged](#) European lawmakers to act accordingly. Although banks had not even come close to their macro-prudential capital buffers, the European Commission on 28 April 2020 [proposed](#) ad hoc legislative changes. The absence of any impact assessment did not stop European co-legislators from [adopting](#) and even extending these micro-prudential measures within just two months.

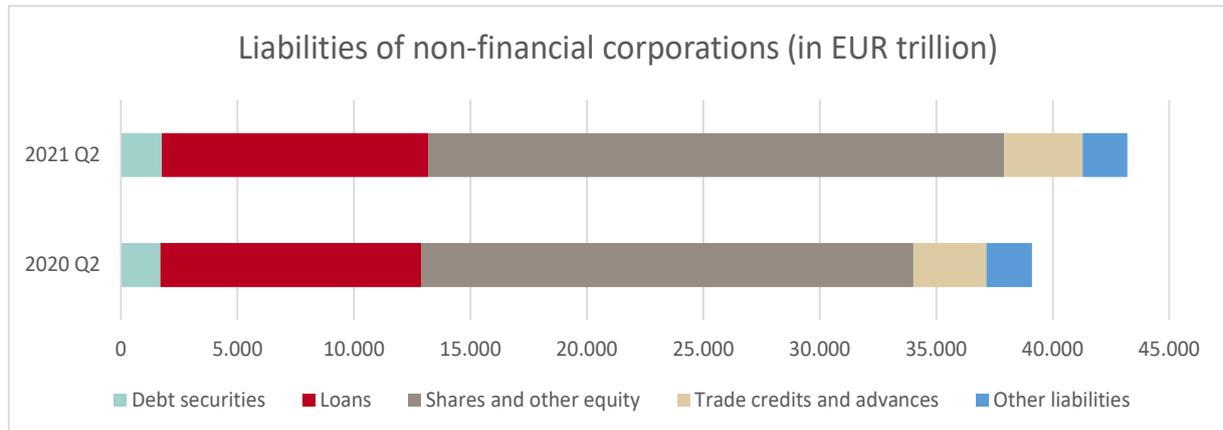
The exceptional amendments to the EU Capital Requirements Regulation (“CRR quick fix”) were [said](#) to maximise the ability of EU banks to lend during the pandemic while also ensuring their continued resilience. In practice, the legislative changes reduced banks’ capital requirements, but banks retained full discretion over their business. Some used the freed-up capital to hand out additional loans, while others kept the credit supply pretty well unchanged and held the newly available capital as a [safety cushion](#) for future losses. In addition, the lowering of capital requirements reduced the trigger point for automatic pay-out restrictions that apply if banks fall below their capital buffers. As a result, weakly capitalised banks were able to continue making distributions other than dividends.

Despite the tremendous economic crisis, banks paradoxically appeared better capitalised during the pandemic than they were before. The common equity tier 1 (CET1) capital ratios of euro area banks on average [improved](#) in 2020 by around 60 basis points to 15.4%. The reasons are threefold. First, supervisory flexibility and legislative changes lowered risk-weighted assets and thus increased capital ratios [on paper](#). Second, the effects of the economic fallout were delayed by public guarantees and moratoria largely offsetting credit losses. Third, dividend restrictions created additional capital for lending or absorbing losses. While Europe successfully maintained financial stability, the impact of the mainly micro-prudential policies on bank lending remains unclear. On a sample of 27 banking groups in ten EU member states, research commissioned by the Committee for Economic and Monetary Affairs in the European Parliament [finds](#) that the CRR quick fix measures have improved banks’ credit supply.

Aggregated data for the euro area, however, [shows](#) that banks expanded traditional loans to companies only slightly. While the liabilities of non-financial corporations (NFC) increased by 10.5 percent year-on-year from Q2 2020 to Q2 2021, loans (including loans within companies of the same group) increased only by 2.1 percent. Chart 1 illustrates that the bulk of additional financing for the real economy came from other sources than bank loans: debt securities issued by NFCs

increased by 3.7 percent, shares and other equity rose by 17.1 percent, trade credits and advances increased by 7.5 percent whereas other liabilities decreased by 2.1 percent. The fact that companies mainly relied on funding sources other than bank loans to meet their increased financing needs casts some doubt on the recourse to legislative changes intended to maximise bank lending.

Chart 1: Liabilities of non-financial corporations



Source: ECB [Sector Accounts](#)

It is fair to say that fiscal, monetary and prudential policies together kept the European economy afloat and prevented systemic deleveraging. Europe avoided a credit crunch. However, given the limited increase in lending to companies, it is debatable whether banks can rightly [claim](#) to be part of the solution. While political decision-makers stretched the standards of good legislation in adopting legislative changes without knowing their effects, banks' contribution to the stabilisation and recovery of the European economy remained rather limited. While no one knows what would have happened without the micro-prudential measures, the pandemic has in any case exposed the European macro-prudential framework's shortcomings.

2 Macro-prudential space was limited when the pandemic hit

To increase banks' loss-absorbing capacity and avoid procyclical behaviour, the Basel III reforms following the global financial crisis require banks to hold capital buffers on top of the regulatory minimum (see Box 1). In the European framework laid out in the EU Capital Requirements Directive ([CRD](#)), these buffers include the capital conservation buffer (CCoB), the counter-cyclical capital buffer (CCyB), buffers for global and other systemically important institutions (G-SIIs and O-SIIs), and the systemic risk buffer (SyRB). All these buffers together constitute the combined buffer requirement (CBR).

Box 1: Capital buffers

On top of the regulatory minimum, banks must hold capital buffers designed to cushion the effects of stress and ensure that banks can continue to lend to households and companies in any economic downturn. Capital buffers sit above the minimum capital requirements. According to the [EU Capital Requirements Directive](#), capital buffers include the following:

The **Capital Conservation Buffer (CCoB)** ensures that banks have an additional layer of usable capital that can be drawn down when losses are incurred. It is established as a fixed, uniform amount across banks.

The **Countercyclical Capital Buffer (CCyB)** is a time-varying capital requirement determined by domestic authorities. It is built up during periods of excessive credit growth that may threaten banking stability. In stress periods, authorities can reduce the CCyB to support banks in maintaining their supply of credit or other critical financial services to the economy.

The **capital buffer for global systemically important institutions (G-SII)** applies to large, highly interconnected and internationally active banks. The **capital buffer for other systemically important institutions (O-SII)** applies to banks that are important to the functioning of their country's national economy. The more systemically important the bank, the higher its additional capital buffer requirement will be. When a bank is considered systemically important both nationally and globally, it must apply the higher of the two buffers (G-SII or O-SII) alone.

The **systemic risk buffer (SyRB)** is intended to counteract systemic risks which could lead to serious disruption of the domestic financial sector or the domestic real economy. The SyRB is imposed on certain groups of institutions or even all groups of institutions. Several systemic risk buffers for different risk positions may apply at the same time.

Above their regulatory buffers, banks keep **management buffers** to cater for the volatility of their balance sheets. They are entirely under the discretion of banks' management and ensure that banks constantly remain above the **combined buffer requirement (CBR)**.

Any violation of the CBR would lead to **automatic distribution restrictions**. Restrictions on dividends, share buybacks, coupon payments on Additional Tier 1 capital, and variable remuneration for risk takers seek to taper the amount of distributions that banks are permitted to make as their capital position deteriorates.

Table 1 gives an overview of prudential buffers in the EU framework and their features. The CCoB is set at a constant rate of 2.5% of a bank's risk-weighted assets. The calibration of all other capital buffers is decided by national macro-prudential authorities reflecting domestic credit growth (CCyB), bank's structural importance (G-SII and O-SII) and the emergence of systemic risks (SyRB). The ECB has the power to apply [more stringent measures](#) but has not exercised this top-up option yet. The CCyB is the only buffer that is releasable, i.e. authorities may wind it down to zero if need be. Buffers other than the CCyB cannot be released, but authorities may allow banks to use them. If banks then eat into non-releasable buffers, they face restrictions on distributions.

Table 1: Overview of prudential buffers

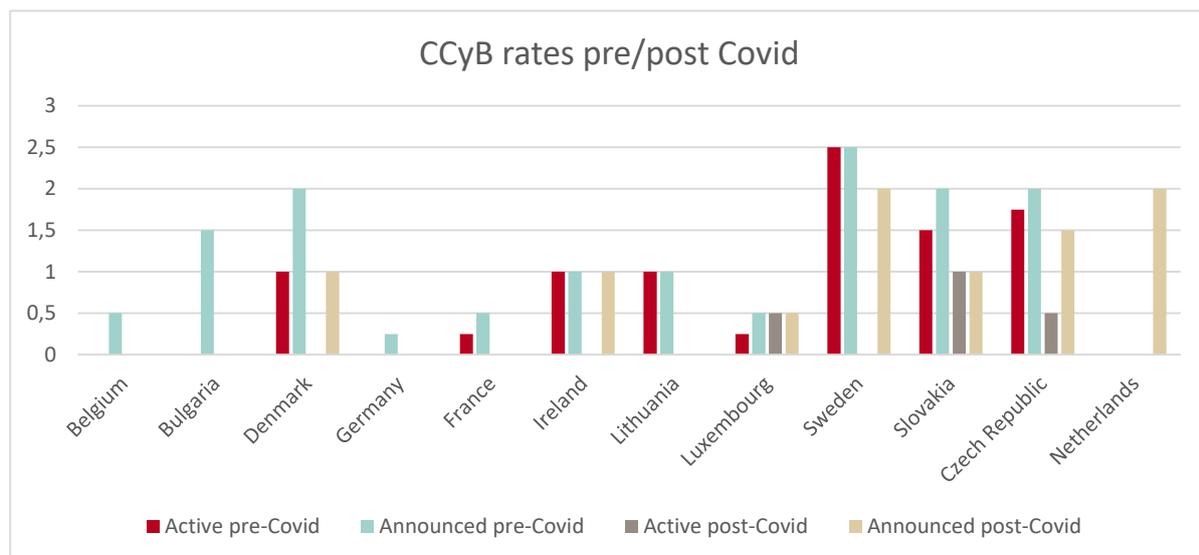
| Buffer | Releasable | Usable in bad times | Distribution restrictions in case of violation | Applicable rate |
|-------------|------------|---------------------|--|---|
| CCyB | YES | YES | NO (if released) | Variable, dependent on financial cycle |
| CCoB | NO | YES | YES | Constant at 2.5% |
| G-SII/O-SII | NO | YES | YES | Constant, dependent on bank riskiness |
| SyRB | NO | YES | YES | Variable, dependent on risk environment |

As the only releasable buffer, the CCyB is the main instrument to dampen excessive procyclicality. In times of elevated credit growth, authorities may increase the buffer rate and thus require banks to build up additional capital. When signs of a crisis emerge, authorities may reduce the buffer

rate so that banks must cut back their lending as little as possible. The European Systemic Risk Board (ESRB) issued a [Recommendation](#) for the use of the CCyB by national authorities in the EU. However, implementation in practice [differs](#) substantially across countries. The main reference indicator used for deciding on the applicable buffer rate is the deviation of the credit-to-GDP ratio from its long-term trend.

To release a buffer, you must first build one. However, when the pandemic struck, the effect of releasing the CCyB was limited in Europe. Many countries had not set a CCyB, in part as the credit-to-GDP gap has shown deeply negative values since the outbreak of the global financial crisis. As a result, the ECB [estimates](#) that out of the €200 billion in total capital relief provided to banks, only €20 billion can be attributed to macroprudential buffers. Chart 2 illustrates the applicable CCyB buffer rates for all EU countries with an active or announced positive rate pre- or post-Covid-19. Only eight out of 27 EU member states had applied a positive rate by the end of 2019 and only six of them had set a rate of 1.00% or higher. Three countries had announced they would introduce a CCyB in 2020 but rescinded this decision when the pandemic hit in spring 2020. To widen the macro-prudential space in responding to the pandemic, some EU countries [reduced](#) SyRB, G-SII and O-SII buffer rates, although those structural buffers are not meant to be released in times of stress.

Chart 2: CCyB rates pre/post Covid.



Own illustration. Source: [ESRB](#).

Unlike the 27 EU member states, the [United Kingdom](#) (UK) maintains a CCyB rate above zero even in the absence of excessive credit growth. That means that in the UK, the CCyB rate is positive before the level of risk becomes elevated. If credit expansion or stress tests of the banking system indicate heightened risks or insufficient capacity to absorb a macroeconomic downturn, then the CCyB is increased further. Should any risks materialise, the CCyB will be reduced, if necessary to zero. The UK Financial Policy Committee has set the positive neutral CCyB rate that banks must hold par default at 2.0% of banks' domestic exposures, but it may change this expectation depending on the evolution of banks' resilience to economic shocks.

There are four compelling reasons for a positive neutral CCyB rate. First, a sufficient run-up time is required because the statistical data on the credit-to-GDP gap only become available with a time lag. Second, a new buffer rate can become binding only after twelve months as banks need time to adapt their capital planning accordingly. Third, to prevent an overreaction to the announced measure and minimise the impact on banks' cost of equity, it can be advantageous to phase in

a gradual increase in the buffer rate. Fourth, the strategy of moving early provides the banking system with a positive buffer that can be cut in the event of an unforeseen shock like the pandemic.

Building on the negative experience made in the pandemic, [four](#) EU countries now intend to follow the UK's lead and set a positive neutral rate in future: Denmark (1.00%), Ireland (1.00%), Sweden (2.00%) and the Netherlands (2.00%). However, creating additional macro-prudential space is not sufficient. The release of capital buffers and permission to use them proves effective only if prudential requirements other than own funds are not more binding. Buffer usability is the second challenge that the pandemic brought to the forefront with regard to the macro-prudential framework.

3 Overlap of regulatory requirements constraining buffer usability

Complementing the release of the CCyB by macro-prudential authorities, ECB and national supervisors allowed banks to temporarily [dip](#) into their non-releasable CCoB when the pandemic struck. This move reflects [evidence](#) that drawing on buffers in a downturn can benefit the economy. Like the release of the CCyB, permission to use the CCoB is supposed to eliminate any constraints on lending. Although banks face restrictions on distributions when dipping into the CCoB, recent [findings](#) suggest that using capital buffers is more beneficial than deleveraging and losing profitable market share.

Despite the economic welfare benefits, only nine out of the 114 large banks now under direct ECB supervision did [dive](#) into their buffers in 2020. The following have been [mentioned](#) as possible reasons for banks' limited use of existing buffers:

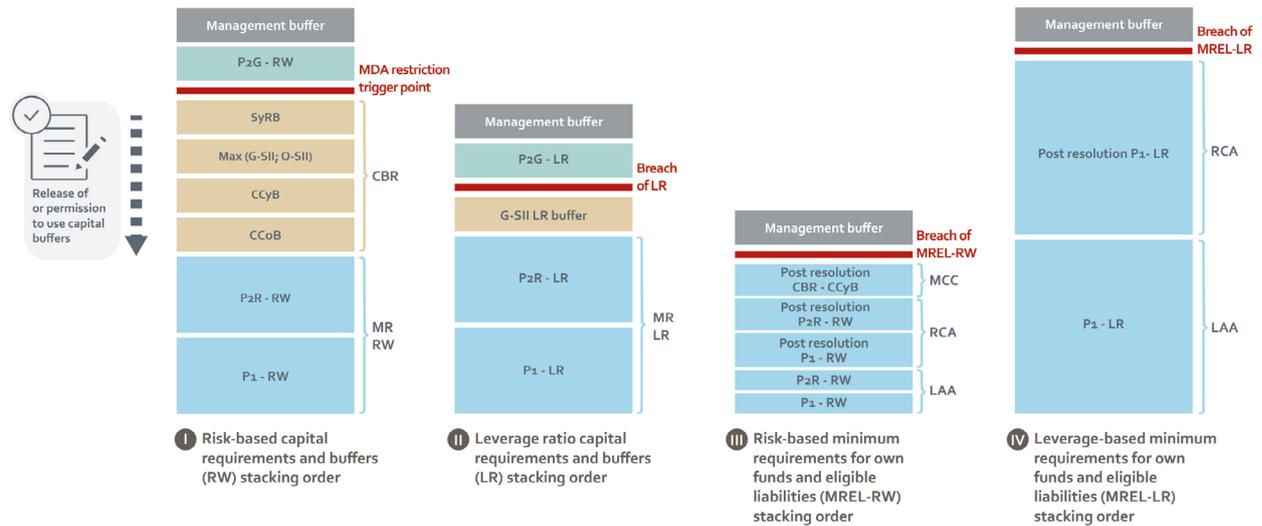
- concerns about triggering restrictions on distributions that could prompt negative reactions among market participants,
- fears of rating downgrades leading to higher refinancing costs,
- uncertainty with respect to the time banks would have to restore their capital buffers, and
- banks' ability to continue to lend without using the buffers, partly because of lowered capital requirements.

Another important constraint for the use of capital buffers is the fact that banks have to comply not only with the minimum own funds requirement but also with extra regulatory requirements in parallel. Since those other requirements have not been reduced when the pandemic hit, banks cannot eat into their capital buffers or use released capital if they still [need](#) that equity to meet those other requirements.

Figure 1 shows a stylised example of the four different regulatory requirements that banks in the EU must comply with in parallel. The risk-based minimum own funds requirement (I) and the non-risk-based leverage ratio requirement (II) together are meant to cover unexpected losses and ensure that banks stay solvent in a crisis. The risk-based Minimum Requirement for Own Funds and Eligible Liabilities (III), aka MREL-RW, and the leverage-based Minimum Requirement for Own Funds and Eligible Liabilities (IV), aka MREL-LR, together are supposed to repay depositors and senior creditors in any bank insolvency.

Figure 1: Regulatory requirements and constraints for buffer usability

Regulatory requirements and constraints for buffer usability



Note: Stylised example of a G-SII, not to scale. Source: Own illustration based on [Banco de Portugal](#). Key: RW – Risk-weighted; LR – Leverage Ratio; MREL – Minimum requirement for own funds and eligible liabilities; MR – Minimum Requirement; P1 – Pillar 1; P2R – Pillar 2 Requirement; P2G – Pillar 2 Guidance; CCoB – Capital Conservation Buffer; CCyB – Countercyclical Capital Buffer; G-SII – Global Systemically Important Institution; O-SII – Other Systemically Important Institution; SyRB – Systemic Risk Buffer; CBR – Combined Buffer Requirement; LAA – Loss Absorbing Amount; RCA – Recapitalisation Amount; MCC – Market Confidence Charge.

The simultaneity of these different types of regulatory requirements makes their interaction more complex. The fact that the same amount of own funds can be used to fulfil more than one regulatory requirement may affect, in certain cases, the effectiveness of a buffer release or the permission to dip into buffers. As far as MREL-RW is concerned, it does not pose any problems for the usability of buffers since the law excludes the use of own funds earmarked for the combined buffer requirement (CBR) to meet MREL-RW. However, in the case of LR and MREL-LR, double counting of own funds already used to comply with the CBR is possible, and this can potentially restrict buffer usability.

In concrete terms, banks may benefit from the release of macro-prudential buffers or permission to use them (sand in the first bar from the left) only as long as they remain above their minimum leverage ratio requirement (MR LR) including the G-SII leverage ratio buffer, if applicable (sand in the second bar from the left). Buffer usability can never conflict with MREL-RW (third bar from the left) since the CBR must be built with capital that is not used to fulfil MREL-RW. However, if a bank doesn't have eligible liabilities above its MREL-LR requirement, then it may not profit from any release of macro-prudential buffers or permission to use them as this would immediately lead to non-compliance with MREL-LR (fourth bar from the left).

Although LR and MREL-LR are still about to be phased-in, they already have a binding effect on banks' capital planning and investor expectations that already take into account the fully-loaded effects. In June 2021, the minimum leverage ratio (LR) of 3% turned from a reporting requirement to a binding capital requirement and, from January 2023 onwards, G-SIIs will be required to hold an additional LR buffer amounting to 50% of the G-SII risk-based buffer. As for MREL, banks have to meet intermediate objectives in January 2022 and final targets by January 2024. Going forward, the restrictions on buffer usability will thus increase further. The problems will be particularly pronounced for banks using internal models to calculate their own funds requirement, since for them the LR often is the more binding requirement.

4 Recommendations

To improve the current macro-prudential framework, banks need additional and usable capital buffers. This requires two things:

- Introduce a Europe-wide positive neutral rate for the CCyB. This would increase the macro-prudential space and guarantee a constant capital cushion for unexpected shocks in all EU countries. To ensure a level playing field within the Single Market, the positive neutral rate would ideally be anchored in Article 136 (1) of the Capital Requirements Directive (CRD). The applicable positive neutral rate could be set in an implementing act adopted by the European Commission after consulting the European Systemic Risk Board (ESRB) and the European Banking Authority (EBA). It would be subject to amendment depending on banks' resilience to economic shocks as determined in EU-wide stress tests. National macro-prudential authorities would be able to reduce the applicable buffer rate only by providing justification that the national financial system is entering a period of stress or losses are likely. Until a common lower bound for the CCyB rate is enshrined in EU law, the ECB could make use of its powers to apply more stringent measures than those adopted nationally and require all banks under its remit to hold enough capital to absorb a macroeconomic downturn of the magnitude of a negative stress test scenario.
- Exclude the use of own funds earmarked for the combined buffer requirement (CBR) to meet the leverage ratio (LR) or the leverage-based minimum requirements for own funds and eligible liabilities (MREL-LR). This would reduce the current overlap of risk-weighted and leverage-based regulatory requirements that banks must comply with in parallel and make capital buffers more usable. As things stand at present, Article 128 CRD prohibits banks only from meeting the risk-weighted minimum requirements for own funds and eligible liabilities (MREL-RW) with capital already used to fulfil the combined buffer requirement (CBR). To increase buffer usability, this provision would have to be extended to the LR and the MREL-LR. Eliminating the double counting of CBR capital across all different regulatory requirements would significantly improve banks' ability to eat into their buffers or to use released capital.

The European Commission is aware of the problems involving macro-prudential space and buffer usability and sent a [call for advice](#) to the EBA, the ESRB, and the ECB regarding the review of the macro-prudential framework. They are expected to submit their views and analyses by 31 March 2022. This paper has shown that only additional and usable capital buffers will improve banks' resilience to economic shocks. Once EBA, ESRB and ECB provide empirical evidence, political decision-makers should act accordingly. Since constraints on buffer usability will increase over time, strengthening the operability of the macroprudential framework before the next crisis hits is vital.

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