Non-paper: Continuing to strengthen the resilience and functioning of the EU banking system

Europe has a robust banking sector that has been able to weather several storms in the past years thanks to the implementation of the Basel standards and sound supervision. Shocks came from unexpected events (the corona pandemic and the war in Ukraine, and the resulting disruption of supply chains and steep increase in inflation) or involved interest and liquidity risks related to relatively safe assets (gilts crisis, a number of failing mid-sized US banks). These experiences highlight the need of a resilient financial ecosystem that is able to absorb instead of amplify shocks, while maintaining a well-functioning channel of credit supply to the real economy. On average, the European banking sector is equipped with large capital and liquidity buffers, significantly bigger than before the Great Financial Crisis. Yet, the stability of the EU banking system cannot be taken for granted. The recent market stress has highlighted that several aspects require further attention. Some preliminary reflections and lessons can be made.

First, strong regulation makes for strong banks. A quick and faithful implementation of the finalisation of the Basel III standards is important, with minimal and restricted transitional arrangements or exceptions, like those for low risk mortgages and unrated corporates. Temporary exceptions that create deviations from the Basel framework and differences between prudential and accounting rules, such as the temporary prudential filter, should be abolished to ensure transparency and trust in EU banks. Similarly, a full and timely implementation of the Basel standard on crypto-assets is needed, because banks' exposures to crypto assets should be covered by sufficient regulatory capital.

Second, banks should be able to use their high quality liquid assets (HQLA) to meet outflows in periods of stress with no or limited impact on regulatory capital. Recent developments have shown that deposits can flow out quicker than before due to the ongoing digitalization. This calls for a quick review of the liquidity framework, as outflow assumptions in regulation, which may be too low in times of crisis. In particular, the parameters for the outflows of less stable retail deposits in the Liquidity Coverage Ratio (LCR) may need reassessment. The use of assets not valued at fair value for accounting purposes as HQLA should also be reviewed.

Thirdly, the recent developments reaffirm the need for the EBA monitoring exercise on the working of the interest rate risk framework in the EU. Furthermore, an assessment on whether Interest rate risk in the banking book (IRRBB) should be added to the Pillar 1 framework in the Basel standards would be important. The assessment of the LCR and the IRRBB framework can be done in liaison with the planned Basel Committee stocktake. A strong and coordinated EU position on these issues should be pursued.

Finally, avoiding the need for unexpected forms of public support for banks is necessary. Prevention is the first and most important line of defense, besides an adequate crisis management framework. Sufficiently large capital buffers ensure that banks can absorb significant losses without losing market confidence. Nevertheless, despite the important reforms, banks remain highly leveraged institutions, with leverage of more than 1 to 18.[1] A funding mix with more equity helps to reduce systemic risks and holding more capital also brings benefits for banks.[2] Well-capitalised banks usually face lower

[1] The average leverage ratio of SSM banks was 5.49% in Q4 2022: Publication of supervisory data (europa.eu)

[2] The evaluation of the Basel reforms found that 'market-based measures of systemic risk declined after the introduction of the Basel III capital and liquidity reforms, suggesting that banks and the financial system have become less vulnerable to the distress of individual banks.' (BCBS (2022), Evaluation of the impact and efficacy of the Basel III reforms, p. 26).

funding costs.[3] Banks' cost of equity and debt decreased after the Basel III reforms, suggesting that improved resilience lowers the cost of accessing capital markets.[4] In this regard, a more effective buffer framework on top of the hard minimum and Pillar 2 requirements is needed to improve resilience and strengthen market confidence and to increase the ability to absorb shocks, before the more drastic consequences of breaching minimum requirements kick in.[5] We therefore stress the importance of extending the G-SII leverage ratio buffer to O-SIIs, in order to increase unweighted capital buffers and improve the shock-absorption capacity of banks that are systemic for the financial system. Similarly, it needs to be clear that setting a positive neutral rate of the countercyclical buffer is possible so that buffers can be built up in time and subsequently released in face of a shock. Improving the buffer framework should therefore be a top priority for the coming years.

[3] The Basel committee also found that 'banks complying with the Basel III requirements lowered their costs of both debt and equity.' BCBS (2022), Evaluation of the impact and efficacy of the Basel III reforms, p. 3.
[4] BCBS (2022), Evaluation of the impact and efficacy of the Basel III reforms, pp. 47-53.
[5] Hence, in an effective framework, capital in the form of buffers has certain benefits compared to capital in the form of minimum requirements.