



Financial resilience in banking: a balancing act

The new reality publication series

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New publication series

The EMA FS Risk & Regulatory Insight Centre (RRIC) is pleased to publish the fifth paper in its new thought leadership series ***Financial Services: regulating the new reality***.

As the focus of government and businesses moves from initial response to the COVID-19 pandemic, through resilience concerns, to recovery and the new reality, financial services regulators are also expected to move into a new phase of adjustment and support.

This paper looks at financial resilience in the banking sector from a regulatory and industry perspective, from the initial measures taken to support banks and their customers, to the longer-term impact of those measures and the potential for unintended consequences.

Over the coming months, look out for further articles and papers in which we will continue to build on the themes identified in the first overview paper.

Financial services: regulating the new reality

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Executive summary

The COVID-19 pandemic was a purely exogenous shock and banks contributed substantially to supporting emergency responses across the globe. Banks have been called on to assist governments and central banks in maintaining financial stability and providing support to the real economy.

The distinctive feature of supervisory responses was speed – within their mandates, regulators were able to use maximum flexibility and provide immediate support. This was critical for banks, to avoid amplification of the crisis. Governments and central banks also intervened, at national and international level, to introduce fiscal and monetary policy measures where required.

In this crisis, banks have been part of the solution not the cause. Requirements introduced in the wake of the last crisis have demonstrated that the banking sector is measurably more resilient than it was in 2008. Banks entered the pandemic with more capital and better liquidity compared to previous crises and, as a result, were able to support customers, keep credit flowing and maintain financial stability.

Unprecedented economic impact

The Bank of International Settlements (BIS) early review¹ of the macroeconomic effects of COVID-19, published in April 2020, predicted that this pandemic would be not only the most serious global health crisis since the 1918 Spanish Flu, but that it was likely to be **“one of the most economically costly pandemics in recent history”** due to the **“unprecedented and synchronised global sudden stop in economic activity induced by containment measures”**.

The BIS estimated that the negative impact on global GDP growth for 2020 would be around 4%, with substantial downside risks if lockdown policies were prolonged. It also predicted larger output losses for major economies. In June, The World Bank predicted² the worst recession since World War II and contractions in the economies of the US, Europe and Japan of 6.1%, 9.1% and 6.1% respectively for 2020.

Emerging challenges

Responsibility for delivering the benefits of many emergency COVID-19 measures agreed by governments, central banks and regulators fell to the banks. To alleviate the pressure and ensure that banks could continue to support customers, regulators relaxed capital and liquidity requirements, extended reporting deadlines and reprioritised supervisory programmes, in some cases cancelling or postponing non-critical activities. Key regulatory actions included deferral of the final Basel reforms, introduction of the Capital Requirements Regulation (CRR) “quick fix” and postponement of stress testing.

However, as the pandemic evolves and banks continue to be called on to help, significant challenges to their profitability and future financial resilience are emerging. The persistent low interest rate environment was already a concern pre-COVID. The issues are not just cyclical, but structural.

¹ BIS Macroeconomic effects of Covid-19: an early review – April 2020

² World Bank Group Flagship Report: Global Economic Prospects June 2020

Non-performing loans (NPLs) will increase, capital and liquidity ratios have moved backwards despite regulatory forbearance, transitional relief from IFRS9 will reverse with potential capital headwinds, leverage ratios will lead to expansion of central bank balance sheets and there is excessive procyclicality around capital ratios and risk weighted assets (RWAs).

Dividend restrictions also weigh heavily. The debate continues as to whether remaining elements of the Basel framework can be implemented in a safe and timely manner, and if so, whether this is the wisest course of action given the burdens already on banks. Forward-looking regulatory priorities such as sustainable finance, digital resilience and innovation must also be addressed.

All these challenges are compounded by uncertainty, around how long the pandemic might last and the final economic impact.

Considerations for regulators

Regulators and supervisors too must look to the future and ensure that they are adapting to the new reality.

They will be monitoring closely the ongoing financial resilience of firms and have suggested that they will be proactive and pragmatic in their responses as banks move into and through the recovery phase. Some initial regulatory concessions have now expired or been withdrawn, some are nearing their end-dates and others continue or have been extended.

As they look ahead to their agendas for the next year and beyond, regulators face difficult decisions about the extent to which their actions can now support or impede the recovery. They will need to consider whether their own approaches and supervisory processes remain appropriate in some areas. Regulatory priorities which temporarily took a back seat in the earlier days of the pandemic are also firmly back in focus.

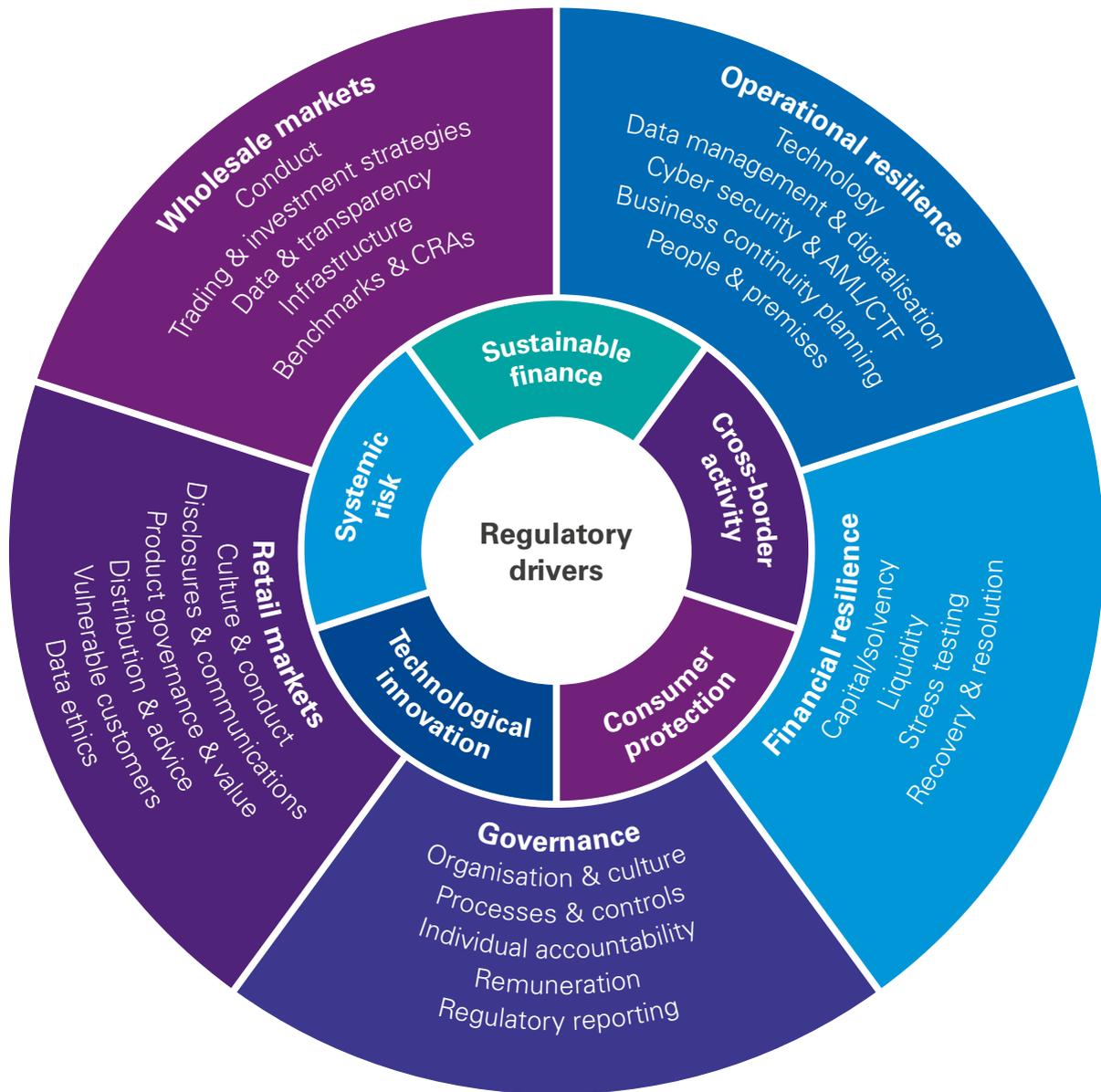
“ There is no doubt that the economic situation we face today is characterised by profound uncertainty. Looking into the future has rarely been harder. ”

Christine Lagarde,
President of the European
Central Bank (ECB)

Key messages

- Banks will be critical to supporting the recovery, but face substantial challenges to their own profitability and financial resilience from low interest rates and declining asset quality
- Prolonged restrictions on bank dividends and distributions may reduce appeal to investors and negatively impact banks' ability to raise capital
- Expected credit losses and non-performing loans will increase as the full impact of the pandemic is revealed. Credit under-provisioning must be addressed to avoid future issues in capital planning
- Banks are encouraged to make full use of regulatory buffers in times of stress, but may be reluctant to do so due to uncertainty around impact on ratings and timeframe for rebuilding reserves
- Consolidation in the banking sector may increase resilience of the sector as a whole and is expected as vulnerable banks struggle due to the pandemic
- Regulators are expecting banks to deliver on sustainable finance and a greener recovery
- Operational resilience is also under increasing regulatory scrutiny to ensure that it does not negatively impact financial stability
- New technologies and increasing digitalisation of the banking sector bring benefits, but also new risks and challenges
- Continued regulatory collaboration will be key to delivering a resilient recovery

Financial resilience: A key regulatory priority



Regulators are concerned about the financial resilience of banks as we move from the response phase, through recovery, to the new reality.

Five key drivers are influencing priorities in regulatory agendas. Consumer protection and financial stability are the bulwarks of much financial services regulation, but the impacts of the pandemic and lock-down measures have brought additional topics to the fore. Volatility in capital markets has led to a renewed focus on systemic risk in relation to margin, computer-led trading strategies and certain types of funds. Also, the pandemic has accelerated trends in the use of technology and demands for sustainable finance, and there are new challenges to doing business across borders. These three trends are now equally prominent drivers of regulatory priorities.

01. Challenges and unintended consequences

The fallout from COVID-19 will be with banks for a long time and the extent of the damage has not yet been fully realised. Non-performing loans will increase, with credit provisioning widely expected to peak in Q4 2020 and Q1 2021. Dividend restrictions are still in force but, if extended for too long, risk becoming a drag on profitability. At some point, capital buffers will need to be restored to pre-pandemic levels.

Generally, banks have stood up well to the economic shock of the pandemic, with swift central bank and regulatory responses instrumental in supporting them and their customers through the initial phase of the crisis. However, there is recognition that coming out of the crisis will be hard, with a possible 'W' shaped recovery. An extended severe scenario that would require further support seems increasingly likely.

The banking sector will be expected to continue to support the recovery once the most acute phase is over, but it faces substantial challenges of its own. Reducing risk in one area could cause it to move to or increase in another area and some support measures may have unintended consequences. Banks have done much to rehabilitate their reputations since the 2008 financial crisis and will be reluctant to be seen to do anything to undermine recovery this time around. Continuing pressure and expectations from governments and regulators may require them to take actions that are not in the best interests of their own longer-term survival.

“ Banks entered this crisis with much stronger balance sheets than the last one – with more and higher-quality capital, more liquid assets, and less reliance on fragile funding. This is a testament to reforms implemented ... in the aftermath of the Great Financial Crisis. Not surprisingly, however, the magnitude of the economic and financial disruptions from the COVID event posed some major challenges.³ ”

Randal K Quarles, Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System and Chair of the Financial Stability Board (October 2020)

Evolving risks

The growing challenges to banks were highlighted in the European Supervisory Authorities' (ESAs') joint risk assessment⁴ in September 2020. This identified the increase in valuation, liquidity, credit and solvency risks across the board in the European financial sector.

Concerns persist around the lower-for-longer interest rate environment and the impact on bank profitability. Uncertainty around the medium and long-term economic consequences of the pandemic remains very high, potentially leading to a fragile market environment going forward.

The ESAs flagged the risk of decoupling of financial market performance from underlying economic activity, which could hamper the sustainability of the market recovery. As banks look to recapitalise, healthy capital markets will be essential. For more on the disruption to capital markets see our earlier paper “Ensuring Stable Capital Markets.”⁵

Actions recommended by the ESAs:



1. Liquidity – financial institutions should prepare for possible further market corrections and deterioration in financial market liquidity. They should monitor risks and perform stress testing or sensitivity analyses accordingly



2. Asset quality – banks and supervisors should properly assess the quality of loan portfolios and remember that legislative and non-legislative loan moratoria, as well as further policy measures such as loan guarantee schemes, may be of a temporary nature.



3. Capital – banks should ensure their capital planning is forward-looking and should make use of the flexibility embedded in the existing regulatory framework



4. Low interest rates – notwithstanding the importance of continued lending, banks should ensure sound lending practices and that risks are not mispriced



5. ICT and security risks – financial institutions should ensure that appropriate technologies and adequate resources are in place to address data integrity, business continuity and increasingly sophisticated cyber threats, including when outsourcing ICT activities

³ BIS Lessons from COVID-19 stress on the financial system 15 October 2020

⁴ Joint Committee Report on Risks and Vulnerabilities in the EU Financial System September 2020

⁵ KPMG Regulating the new reality: ensuring stable capital markets – September 2020



Expected credit losses and NPLs

From an early stage, the pandemic was expected to have a negative impact on asset quality, with the European Banking Authority (EBA) predicting in May 2020 that NPL volumes could reach similar levels to those recorded in the aftermath of the sovereign debt crisis. The EBA was optimistic that state guarantees introduced in many jurisdictions might soften this impact and that its own Guidelines on loan moratoria would avoid the automatic classification of affected exposures as forborne or defaulted. Nevertheless, it advised banks to ensure that they continued to perform proper risk assessment and noted that impacts on individual banks would vary widely, depending on the trajectory of the crisis, the starting capital level of each bank and the magnitude of their exposures to the most affected sectors. This view was echoed by the International Monetary Fund (IMF) which concluded⁶ that **COVID-19 would worsen pre-existing financial vulnerabilities.**

In July 2020, S&P Global forecast⁷ global bank credit losses of about \$2.1 trillion for 2020 and 2021 as a result of the pandemic, with further waves of COVID-19 likely to increase these estimates.

The extent of provisions made so far varies greatly from region to region and banks' own forbearance actions will determine when they experience the full impact of credit losses. European banks have so far been relatively conservative in their provisioning – in recent years they have worked hard to reduce NPLs, meaning the impact of increases so far has not been catastrophic. US firms have been more aggressive. Whatever the approach, credit losses are expected to peak in Q4 2020 or early 2021 with corresponding increases in expected loss provisions. Instances of credit under-provisioning will need to be addressed to avoid future issues in capital planning.

Some banks have already started work to restructure loans, in order to allow borrowers extra time to recover from pandemic related setbacks and return to regular repayment schedules. However, the likely outcome is that a much higher proportion of loans than usual will go bad and require recovery. This will add to the operational burden for banks and the risk on their balance sheets. For government-backed loans there may also be challenges in operationalising the use of guarantees.

If loans fail, banks will have to make difficult decisions about which sectors and clients to support, to avoid inadvertently propping up so-called "zombie companies". At the same time, they will want to find an appropriate balance to enable companies with future potential to continue operating. There will be also be challenges in supporting retail customers, not least in keeping up with the vast amount of guidance that regulators are issuing.

6 IMF Blog: COVID-19 worsens pre-existing financial vulnerabilities – May 2020

7 S&P Global: The \$2 trillion question: What's on the horizon for bank credit losses – July 2020

Dividends and distributions

National and regional regulators have taken varied approaches to bank dividends and distributions with eurozone and UK banks experiencing some of the most stringent initial restrictions.

In March 2020, the ECB recommended that, until at least 1 October 2020, credit institutions should not pay, or make commitments to pay, dividends for the financial years 2019 and 2020 and should refrain from share buybacks aimed at remunerating shareholders.

In the same month, the EBA urged⁸ all banks to refrain from dividend distributions or share buybacks resulting in a capital distribution outside the banking system, “in order to maintain its robust capitalisation”. In June 2020, the European Systemic Risk Board (ESRB) further recommended⁹ that the EU bank dividend freeze be extended past October 2020 and in July the ECB extended¹⁰ its recommendation not to pay dividends until January 2021.

Also in March 2020, the Prudential Regulation Authority (PRA) asked¹¹ large UK banks to cancel any outstanding 2019 dividends and cash bonuses to senior staff, including material risk-takers, and to suspend dividends and buybacks on ordinary shares until the end of 2020. In December, these restrictions were relaxed, subject to temporary guardrails and close supervisory scrutiny. The PRA intends to return to standard distribution processes through 2021.

The Swiss Financial Market Supervisory Authority (FINMA) took¹² a softer initial approach, cautioning banks not to pay out 2019 dividends in order to conserve capital, without banning them outright.

In the US, banks are still permitted to pay dividends, albeit capped at Q2 2020 levels and limited to an amount based on recent earnings, as announced¹³ by the Federal Reserve in June 2020.

In Canada, contingency measures for distributions are built into the capital regime.¹⁴ Should a bank need to access funds in its Capital Conservation Buffer, dividends and share buybacks will automatically be restricted. Such measures have not yet been activated.

The Monetary Advisory Authority of Singapore called¹⁵ on banks to cap full year 2020 dividends at 60% of full year 2019 dividends and offer shareholders the option of receiving dividends in scrip in lieu of cash.

In July 2020, the Australian Prudential Regulation Authority (APRA) revised¹⁶ its April recommendation that banks defer dividends in favour of a pay-out ratio below 50 per cent for the rest of the year. The regulator has signalled that this may soon be relaxed further.

There was strong initial support for dividend measures in Europe in order to preserve capital, but prolonged restriction of dividends could limit firms’ ability to raise capital going forward. Eurozone banks are quick to point out that this is not a level playing field and that they will become less appealing to investors and therefore less competitive if they continue to be prevented from making distributions.

Banks have also pointed out that, in the interest of expediency, the measure was “one size fits all” and did not distinguish between well-capitalised firms and others. Pressure is mounting on regulators to act, with the ECB due to revisit its position on dividends in Q4 2020.

The EBA maintains its position that restricting dividends was, and remains, the right thing to do. EBA Chair, Jose Manuel Campa, acknowledged the importance of investors receiving appropriate returns under normal circumstances but cautioned that these are not yet normal circumstances.

The Basel Committee on Banking Supervision (BCBS) did not initially take a clear position on dividends, noting that different locations had different approaches to distributions, dividends or buybacks, typically choosing to restrict the format that was most impactful for them. However, in November 2020, Carolyn Rogers, BCBS Secretary General struck a more cautious note, suggesting that dividends should remain on hold until the longer-term impact of the pandemic is clear:

“ Holding back on discretionary distribution of capital [...] makes sense. [...] We are all in this suspended reality. As government support programs expire, some businesses and households will fare better than others, there will be losses and the scale is not clear at this point. There is a long way to go.”¹⁷ ”

Carolyn Rogers, BCBS Secretary General

8 EBA provides additional clarity on measures to mitigate the impact of COVID-19 on the EU banking sector – March 2020

9 ESRB: System-wide restraints on dividend payments, share buybacks and other pay-outs – June 2020

10 Press release: ECB extends recommendation not to pay dividends until January 2021 and clarifies timeline to restore buffers – July 2020

11 PRA statement on deposit takers’ approach to dividend payments, share buybacks and cash bonuses in response to Covid-19 – March 2020

12 FINMA welcomes dividend action taken by major banks – April 2020

13 Federal Reserve Board releases results of stress tests for 2020 and additional sensitivity analyses conducted in light of the coronavirus event – June 2020

14 Statement from the Superintendent on Canadian bank capital and dividends – April 2020

15 MAS calls on local banks to moderate FY2020 dividends – July 2020

16 APRA updates guidance on capital management for banks and insurers – July 2020

17 Financial Times, 17 November 2020, Bank regulator calls for dividends to remain on hold

02. Buffers and Basel

Among the most significant regulatory concessions were the relaxation of buffer requirements and the deferral of implementation of the final Basel reforms by one year.

Banks entered the pandemic with strong capital and liquidity positions, thanks to measures put in place following the 2008 financial crisis. However, there has been a mixed response to regulators' calls for banks to use their buffers as intended in a time of stress. Although capital and liquidity ratios appear to be reducing somewhat, concerns persist amongst banks about the immediate and longer-term implications. And the debate around a further delay to the final Basel reforms continues.

Capital

On average, Common Equity Tier 1 (CET1) ratios for European banks were around 15% in Q4 2019 compared to 9% in 2009, well above the regulatory requirements. One of the most important early actions of the regulatory response was capital relief, with **banks encouraged to make full use of the buffers available**. This added CET1 capital headroom, which enabled banks to continue lending to corporates and households. In many jurisdictions, countercyclical buffers were reduced too, remaining at or close to zero, and banks were given flexibility to operate below their Pillar 2 Guidance (P2G).

As they review the impact of measures, regulators are now asking whether banks are using their capital buffers as intended. The buffer regime was a Basel 3 invention and was designed to be used in a stressed environment. Analysis from the ECB¹⁸ in October 2020 showed that banks' use of capital buffers tended to lead to better economic outcomes, without a negative impact on resilience. Willingness to use buffers was reflected in higher lending, with positive effects on GDP and lower credit losses.

¹⁸ ECB Macroprudential Bulletin – October 2020

However, the ECB has reported¹⁹ mixed reactions to temporary capital relief measures and lowered macro-prudential buffers, with only around one third of banks reducing or withdrawing their internal targets. Some banks have reported overall increases in capital levels, partly due to dividend restrictions, therefore they have not yet needed to dip into their buffers. Others confirm that, despite encouragement from regulators, there is a stigma attached to using buffers, with banks wary of dipping into them due to the perceived reputational impact and possible negative reaction of ratings agencies. It is unclear to what extent the first banks to draw down buffers substantially might expect to receive lower ratings, which are associated with less favourable wholesale funding conditions and can also limit market access.

Uncertainty around how long banks will have to rebuild buffers acts as a further deterrent, with several banks expressing concerns in their public reports about the risk of buffers being rapidly restored to pre-crisis levels. The BCBS has stated that it will be methodical and thoughtful about restoring buffers but has limited its response to broad standard messages that this will depend on banks' profitability and starting points. The EBA has noted that further debate is required on how and when to restore buffers, due to the complexity of the system and the fact that it is not complete, with MREL requirements still being built. The Bank of England has also repeatedly said that banks will be given ample time to rebuild buffers.

There needs to be clear guidance on when banks will be required to start rebuilding their capital buffers.

Looking ahead, banks will need to assess the capital implications of writing off loans and how best to recapitalise post-crisis. Regulators are being asked to consider whether capital models could be adjusted to combat procyclicality. Speaking in October 2020, Sir John Cunliffe, Deputy Governor of the Bank of England noted that it might be necessary **to revisit the balance between the various capital buffers**, with a view to having more in countercyclical buffers that are releasable by regulators, and less in fixed buffers, adding that any future decision would depend on the progress of the recovery, level of impairments and how permanent the damage is.

Leverage ratio

In addition to encouraging banks to use their buffers, regulators exercised discretion and provided valuable **temporary relief from the leverage ratio** as a binding constraint. In September 2020, the ECB announced²⁰ that Eurozone banks under its direct supervision could exclude certain central bank exposures from the leverage ratio due to the exceptional circumstances arising from the pandemic.

The CRR "quick fix" permitted banking supervisors, after consulting the relevant central bank, to allow banks to exclude central bank exposures (including coins, banknotes and deposits held at the central bank) from their leverage ratio. Based on end-March 2020 data, this exclusion would raise the aggregate leverage ratio of 5.36% by about 0.3 percentage points.

This announcement was important for globally systemically important banks (G-SIBs) and subsidiaries of foreign G-SIBs, for which the measure additionally provides relief under the already binding total loss-absorbing capacity (TLAC) requirement.

Banks have welcomed this temporary relief, but caution that when it comes to an end there may be some cliff effects. The 3% leverage ratio requirement will become binding on 28 June 2021, in the absence of further regulatory intervention.

Liquidity

Liquidity coverage ratios (LCRs) were also significantly above the regulatory minimum of 100% pre-pandemic. Again, banks were **encouraged to use liquidity buffers** to ensure their short-term resilience to potential liquidity disruptions and to combat deteriorating funding conditions.

This appears to have been effective, but while bank liquidity remains relatively stable, there are indications that there is a need for greater liquidity resilience in non-bank parts of the financial system to avoid further deterioration in asset quality.

An unintended consequence of banks providing liquidity to customers is that some loans issued remain on deposit and are now inflating bank balance sheets. This, in turn, is leading to higher scores for G-SIBs under current rules²¹ and higher systemic risk buffer requirements. Banks have expressed concerns that the current G-SIB framework may result in higher capital requirements than warranted due to the cliff effect at the end of G-SIB bands and are calling for the bands to be revisited post-crisis to ensure that the framework functions as intended.

The BCBS has acknowledged this potential effect but notes that further analysis is required to identify whether expansion of balance sheets is adding to banks' systemic footprint or is, in fact, riskless.

19 ECB Macroprudential Bulletin – October 2020

20 ECB press release – September 2020

21 BIS GSIB Framework October 2018



Outlook for Basel 4

One of the major regulatory concessions in the early days of the pandemic was the BCBS decision, in March 2020, to defer implementation of the final Basel reforms (widely referred to as Basel 4) by one year. Most of the reforms will now be implemented by 1 January 2023, with the output floor phased in between 1 January 2023 and 1 January 2028.

Perhaps unsurprisingly, banks and regulators are at odds on moving to the next phase of Basel implementation, with regulators coming under increasing pressure to review.

Industry has called out the burden already on banks and recommended more detailed impact assessments to consider European specificities, including proportionality, and to avoid premature delivery of the CRR3 proposal (now tabled for Q1 2021). Longer term concerns are being raised around bank profitability and the need to avoid piling more pressure onto an already stretched banking system.

Banks have flagged the unprecedented levels of support that they are providing to customers. Regulatory measures such as the CRR “quick fix” have

been helpful, but banks question whether they can continue to support the recovery and, at the same time, implement Basel 4, both of which would likely require them to set aside more capital. They cite the procyclicality of the Basel reforms and note that these were designed in very different economic times and that smaller banks are not supported well by the framework. Banks caution that, in order to avoid a funding crisis, further analysis and a clear understanding of the true impacts of the pandemic are required before a safe implementation of Basel 4 can proceed.

In the UK there has been some movement on the remaining elements of the Basel framework, though not on Basel 4. In November 2020, the PRA announced²² that, following the EU transition period, it aims to implement the remaining elements of Basel 3 by 1 January 2022. Under CRR2 the Eurozone proposes to implement these elements in 2021. The UK announcement was in response to feedback on the specific proposals and industry concerns about the general volume of regulatory reform planned for 2021.

For now, the BCBS and other regulators are holding firm on Basel 4, highlighting the benefits that Basel reforms have already delivered in reinforcing the banking sector during the pandemic and the need to complete the programme to the agreed schedule. However, the European Commission has indicated that it will proceed in a flexible, pragmatic manner. It has asked the EBA to carry out an impact assessment and the ECB to provide further analysis from a macro prudential perspective, ahead of delivery of the CRR3 proposal.

The debate continues: in the current climate, **do the remaining Basel 4 revisions still stand up to scrutiny? And will banks be able to step up to the January 2023 deadline or do the new requirements risk destabilising recovery efforts?**

22 Joint Statement on the implementation of prudential reforms in the Financial Services Bill – November 2020

03. Resolution and stress testing

The longer the crisis continues, the greater the risk to vulnerable banks. Following the 2008 crisis, substantial progress was made to ensure that, in future, banks would be able to fail in a controlled manner, without risk of contagion and negative impact on the financial stability of the wider financial system.

Recovery and resolution planning are in sharp focus as regulators consider the forward resilience of firms. The possibility of creating bad banks to house toxic assets and the role of governments in supporting banks at risk are also being discussed.

Recovery and resolution

The Financial Stability Board's (FSB's) June 2020 evaluation²³ of the too-big-to-fail (TBTF) reforms concluded that:

- Banks are more resilient and resolvable than in the aftermath of the 2008 crisis – they have higher equity capital which makes them better placed to absorb shocks. Supervision has improved and resolution authorities have more tools to deal with failing and distressed banks
- The benefits of the reforms significantly outweigh the costs – the reforms have not been at the expense of lending to the economy or increased fragmentation of financial markets
- There are still gaps to close – the FSB is continuing its work on resolvability of banks and encourages full implementation of the reforms
- Improvements to reporting and disclosures are required

²³ FSB Evaluation of the effects of too-big-to-fail reforms: consultation report – June 2020

In July 2020, the EBA reiterated²⁴ the importance of resolution planning in times of uncertainty to ensure that resolution stands as a “**credible option in times of stress**” and recommended that resolution authorities:

- Consider the impact of COVID-19 on banks and their business models when taking decisions on resolution plans and on the minimum requirement for own funds and eligible liabilities (MREL)
- Use and test resolution colleges as the main fora to exchange information and share decisions in times of stress

In September 2020, Elke König, Head of the Single Resolution Board (SRB) acknowledged²⁵ that the EU resolution framework is not perfect but noted that it does work and has required banks to become better prepared to withstand shocks.

“**The best way to avoid a crisis is good preparation.**”

In October 2020, the European Commission announced plans²⁶ to propose changes to legislation on bank crisis management in Q4 2021 as part of its work to complete the Banking Union and underscore financial stability.

The prospect of increased risk of bank failures has triggered debate over whether governments might need to take stakes in banks again or whether “bad banks” might be necessary at national, European or global level. So far there is little clear development in this space, but in June 2020 Elke Koenig warned against bailing out banks that were unviable before the pandemic struck. She also questioned the viability of plans to create bad banks to take toxic assets off bank balance sheets.

Stress testing

In recognition of the intensity of work required by banks to support stress testing, the Bank of England cancelled the 2020 Annual Cyclical Scenario stress test and postponed the 2021 Biennial Exploratory Scenario (due to start end-2020) which would, for the first time, have included climate scenarios. The EBA also cancelled its 2020 EU-wide stress test.

The BIS has reported²⁷ that, in response to the pandemic, some authorities that regularly conduct stress tests on individual banks adjusted their approach, carrying out ad hoc exercises to assess the vulnerability of specific banking sectors rather than the wider system. These exercises were different from the system-wide ones in terms of objectives, design, methodologies and communication.

The BIS notes that, in the short term, such stress tests can support the assessment of the pandemic’s impact at an aggregate level. As the pandemic evolves and its impact is better understood, authorities can further adjust their stress tests and refine their key features accordingly. This allows for a more granular, bank-level assessment. It may also help authorities to achieve the necessary balance between keeping banks safe and sound and ensuring an adequate flow of credit to the real economy.

The Federal Reserve Board (FRB) issued results for its 2020 stress test and additional sensitivity analyses in June 2020. These sensitivity analyses looked at the resiliency of large banks under three downside scenarios, a V-shaped recession and recovery, a slower U-shaped recession and recovery and a double-dip W-shaped recession. Under the U- and W-shaped scenarios, most banks remained well-capitalised but several approached minimum capital levels. As a result the FRB introduced dividend limits

(see Chapter 1) and will ask banks to resubmit their capital plans later in 2020 to reflect current stresses.

Given the continuing uncertainty, positioning of the next round of system-wide stress tests will be crucial. Whereas in the past stress tests have been largely about ensuring that capital buffers are adequate, often resulting in increases in capital requirements, **the next iteration of tests will require a different narrative, one that reflects the new reality of banks’ efforts to support the wider financial system.**

The EBA confirmed in October that the EU-wide stress test will proceed in 2021, even under a COVID-19 “second wave.” Banks are expected to prepare in accordance with the ECB’s instructions with tentative dates for the various submissions from March to June and publication of results at end-July 2021. The EBA has not indicated major changes compared to the 2020 methodology, but some differences are expected, for example to reflect public guarantees for loan loss projections. Moratoria effects should not be considered.

In November 2020, the Governor of the Bank of England announced²⁸ that the postponed Biennial Exploratory Scenario, based on climate risk scenarios, would launch in June 2021. The results will not be used to size banks’ capital buffers.

24 EBA statement on resolution planning in light of the COVID-19 pandemic July 2020

25 Speech at the SRB Annual Conference – October 2020

26 European Commission Work Programme 2021 – October 2020

27 Financial Stability Institute Briefs: Stress-testing during the Covid-19 pandemic – October 2020

28 Speech: The time to push ahead on tackling climate change – November 2020



04. Resilience in the new reality

COVID-19 has been a catalyst for many changes in the banking sector. As banks and their prudential regulators look ahead, from response to recovery, they will have many issues to consider.

For banks, their own profitability will be paramount. Challenges include those mentioned in the previous chapters, plus the rapidly escalating priorities of embracing sustainable finance and adopting new technologies while maintaining financial and operational resilience. It is likely that we have not yet reached the point of greatest financial strain for banks and they may need additional support going forward.

Regulators will be keen to see the resilience demonstrated so far continue. Performance of prudential frameworks has been encouraging, but global reforms are not yet complete and there are questions about whether banks have the bandwidth to proceed as planned. The COVID-19 impact varies from country to country and recovery speed will vary also, strengthening the case for accelerating Banking Union in Europe. Regulators will need to offer pragmatic solutions and ensure that banks continue to make good use of the concessions and facilities available to avoid cliff effects.

“ Uncertainty is the only certainty there is. ”

Pablo Hernández de Cos,
Chair of the BCBS and
Governor of the Bank of Spain

The case for consolidation

Recovery of the Eurozone is strongly linked to the banking system, but projected returns on equity for banks were already declining pre-pandemic and remain low for 2021 at approximately 2% to 3%.

Profitability for global banks has not yet been as adversely impacted. Initial volatility in markets was a concern but this swiftly came under control (see our New Reality Paper “Ensuring stable capital markets”²⁹). Subsequent stabilisation and an uptick in market activity have more than offset losses in lending operations, leaving global players feeling relatively optimistic for now.

However, banks are still operating against a backdrop of expected increases in NPLs, declining asset quality, lower for longer interest rates and the rising threat of zero or negative rates. They also face growing competition from non-financial technology firms and significant cost challenges.

In the European Union particularly, with its larger number of smaller, potentially less resilient banks, casualties are to be expected and regulators have stressed the need to prepare for consolidation and Banking Union to minimise the negative impacts.

In August 2020, Edouard Fernandez-Bollo, ECB representative to the Supervisory Board spoke³⁰ on the recently published draft guide on the supervisory approach to consolidation. He noted that Eurozone banks have been struggling for some time to earn their cost of equity. He also described 2008 as a missed opportunity to clean up the banking sector.

²⁹ KPMG Regulating the new reality: ensuring stable capital markets – September 2020

³⁰ Speech – Consolidation can secure safe and sound banks – August 2020

Whereas US banks were wound down or failed, far fewer European banks exited the market. Ten years on, weak banks continue to limp on, putting pressure on margins and, ultimately, on the overall capacity of the banking system to continue lending to serve the real economy. In Mr Bollo's words "we will be better equipped to deal with (the future) when our banks are efficient and resilient. Consolidation, when properly planned and executed, can play an important role here."

There will be winners and losers from the pandemic, and weaker banks may not survive. Smaller digital banks may also falter as their business models prove unsustainable in the new reality.

Consolidation may offer a lifeline and boost profitability through economies of scale and greater cost efficiencies. Larger firms will be more likely to have the capacity and resources to absorb losses and invest in digital transformation, which is high on regulators' agendas. However, it may also stifle innovation and competition, and protect only the firms with the deepest pockets.

In Europe there is evidence that consolidation has already begun, but this is likely to be simpler to achieve at domestic rather than EU-level in the first instance. The creation of truly pan-European banks may follow later but will take longer due to the complex eco-system and varying speeds of response at national level.

“ Consolidation can secure safe and sound banks. ”

Edouard Fernandez-Bollo,
ECB representative to the
Supervisory Board

Where banks do consolidate, they will have to navigate the practical complexities of joining forces, not least the need to calculate capital requirements, merge risk profiles, portfolios and internal models and integrate infrastructures. They may also need to consider the potential impacts of negative goodwill.

A greener recovery

Banks are being urged to prioritise a greener recovery to ensure a more resilient future. "We must not let this crisis go to waste," urged Christine Lagarde, president of the ECB.

Climate-related financial risk was already on the agenda before the pandemic. The BCBS Taskforce for Climate Risk (TCFR) is focused on how to translate climate risk to financial risk and put rigour around measurement. The EBA, ECB and Bank of England also have climate risk high on their agendas.

Pressures to build back the banking sector in a greener way bring opportunities but also add further complexity. For more details see our New Reality paper "Delivering sustainable finance".

“ The first crisis is acute and immediate, the second slower burning but equally critical. The two crises are clearly interlinked, because the scale and nature of the economic policy decisions being made now will crucially affect climate outcomes far into the future. So, far from putting climate on the back burner, the pandemic adds to the urgency of addressing it. ”

Tao Zhang, IMF Deputy
Managing Director

Operational resilience and technology

From the start of the pandemic, banks' operational resilience has been under pressure. Banks activated contingency plans and moved uncharacteristically rapidly to develop new processes, which allowed them to keep their core functions broadly unaffected. However, the need to handle large volumes of applications for debt moratoria and guaranteed loans, market volatility and the insufficient preparation of some units to work remotely, added to the challenges.

Operational resilience remains in sharp focus as the counterpart to financial measures in maintaining financial stability. The focus on digital operational resilience more specifically is also increasing as the financial sector's dependence on technology grows, accelerated by the need for remote working solutions during the pandemic. COVID-19 has acted as a catalyst for the increasing digitalisation of finance, bringing new risks and challenges to the banking system. Operational resilience and adoption of new technology will be discussed in more detail in future papers in this series.

Cooperation not fragmentation – the new reality for regulators

Close cooperation between prudential regulators at national, regional and global level and between regulators and banks has been a feature throughout the pandemic and has been instrumental in maintaining financial resilience. Regulators will be hoping that this cooperation can be maintained.

In October 2020, Pablo Hernández de Cos, Chair of the BCBS and Governor of the Bank of Spain spoke³¹ of the fundamental shift in working practices across many sectors and the importance of continuing cooperation on global financial stability to ensure a safe banking system that supports the economic recovery. He stressed the importance of resilience at all times and the need to make the regulatory framework robust to arbitrage and erosion over time.

Mr Hernández de Cos posed several questions for regulators in the new reality:

- Is there a need for a greater layer of usable buffers in “steady state” that can be promptly drawn down in times of stress?
- Should more be done to simplify the regulatory framework – do some unduly complex aspects of the framework make the banking system less resilient?
- Should the framework include greater use of proportionality?
- Should there be a greater prudential focus on bank conduct, ethics and incentives?
- What more can supervisors do to anticipate longer-term systemic risks stemming from outside the financial system?
- Is the balance between regulation and supervision correct?
- Can more be done to promote effective supervisory practices and coordination across jurisdictions?

“ Resilience matters before a crisis emerges..., resilience matters during a crisis..., resilience matters after a crisis... ”

Pablo Hernández de Cos,
Chair of the BCBS and
Governor of the Bank of Spain

He also set out three key developments for supervisors. First, proactive supervision will be increasingly important as the traditional regulatory framework may no longer be effective. Second, greater consideration must be given to the regulatory perimeter to ensure operationalisation of the “same activities, same risks, same rules” principle. Supervisors will need to proactively identify and map interconnections across a broader range of channels in the future. Third, cooperation between different authorities, whether monetary or regulatory will be even more important.

As the banking sector evolves, whether through digitalisation, consolidation or non-bank disintermediation, so must the regulatory and supervisory framework. The FSB’s November 2020 review of the financial stability impacts and policy responses to COVID-19 concluded that early identification of potential vulnerabilities is critical in an environment of heightened economic certainty and financial risk. Effective policy responses require measures to remain in place for as long as necessary and be unwound in a considered and orderly way. And, perhaps most importantly, national authorities’ ability to respond effectively to emerging financial stability risks relies on established, well-functioning mechanisms for cross-border cooperation.

“ History has shown that collective measures to tackle global problems reinforce individual countries’ efforts. This time is not different: ongoing global cooperation is key to ensuring a safe banking system that supports the economic recovery... We must avoid fragmented and disjointed measures. The path of splintered measures will neither stop this virus nor provide the bedrock of safe and sound banking system.³² ”

Pablo Hernández de Cos,
Chair of the BCBS and
Governor of the Bank of Spain



Look out for further articles and papers in this thought leadership series that will consider other ‘new reality’ issues.

31,32 Speech – Covid-19 and banking supervision: where do we go from here? October 2020

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