SUERF Policy Briefs
No 138, July 2021

Three questions on the outlook for banking*

By Carolyn Rogers
Basel Committee for Banking Supervision

Keywords: Banking, bank regulation, buffers, Covid-19, digitalisation, global cooperation, non-bank financial intermediation, provisioning.

We are starting to see light at the end of the Covid-19 tunnel. With all this optimism, what could possibly go wrong for the global banking system? Consider the following three questions. First, as we begin to exit this extraordinary period of uncertainty, are banks adequately managing the risks, or has an inflated sense of optimism taken hold? Worse yet, has complacency set in? Second, what has the past year taught us about the value of international cooperation? Third, the response to the Great Financial Crisis was still in progress when this one hit. Do we have a decade to address the risks that have emerged this time around? Or do we need to move more quickly to address the risks facing the banking sector in the years ahead?

* Keynote speech held by Ms Carolyn Rogers, Secretary General of the Basel Committee on Banking Supervision, at the IACPM Virtual Spring Conference, on 19 May 2021.

Introduction

We are starting to see light at the end of the tunnel. Positive health-related developments, most notably vaccines, have brought some much needed rays of hope. To date, almost 1.9 billion vaccine doses have been administered.[1] A year ago, we would start every conversation with a friend or colleague by exchanging information on case counts. Now those conversations are more likely to start with vaccination counts.

Importantly, that light at the end of the tunnel seems to be translating into economic optimism. After unprecedented fiscal and monetary intervention mitigated an extreme economic fallout, there are clear signs of recovery, and in some parts of the world, growth is even exceeding previous forecasts. With all this optimism, one might ask what could possibly go wrong. But like any regulator, I am good at finding things to worry about.

Accordingly, I will discuss three topics that take up a fair bit of my thinking, if not worrying, these days, which I will frame around three questions.

i) First, as we begin to exit this extraordinary period of uncertainty, are banks adequately managing the risks, or has an inflated sense of optimism taken hold? Worse yet, has complacency set in?
ii) Second, what has the past year taught us about the value of international cooperation?
iii) Third, the response to the last crisis was still in progress when this one hit. Do we have a decade to address the risks that have emerged this time around? Or do we need to move more quickly to address the risks facing the banking sector in the years ahead?

Covid-19 risks and vulnerabilities in the banking system

It has become standard to begin any discussion about Covid-19 and the banking system with the observation that, unlike during the Great Financial Crisis (GFC), banks have thus far been "part of the solution" rather than "part of the problem". In contrast to 2007-09, the resilience of the global banking system has not been called into question, and as a result, banks have been able to maintain the provision of credit and other key services to households and businesses.

This positive story can be attributed to two main factors. First, the unprecedented scale of fiscal and monetary support measures has shielded banks from pandemic's economic fallout. Fiscal support in the G20 economies came to almost 20% of GDP in 2020, while central banks' balance sheets in some of the major economies now stand at close to, or more than 100% of GDP.[2] Second, the banking system entered the pandemic on a much more resilient footing than during the GFC thanks to the initial set of Basel III reforms.[3] And the ongoing cooperation among Basel Committee members in response to the outbreak of Covid-19 was key to ensuring a global, timely and comprehensive response to some of the short-term financial stability issues.

Yet, while economic sentiments are stronger than at any time since the start of the pandemic, there continues to be a wide range of risks and vulnerabilities in the global banking system.[4] I will highlight three that stand out in my view.

[1] Roser et al (2020). All data related to Covid-19 vaccines and cases are as at 30 May 2021.

[2] IMF (2021a).

[3] BCBS (2011, 2017). See Borio et al (2020) for a primer on Basel III and other post-GFC regulatory reforms.

[4] IMF (2012b).

First, the pandemic is still far from over. Despite the growing sense of optimism, the daily rate of new Covid-19 cases remains at a near all-time high, hovering around the 500,000 mark, and to date just over 5% of the world's population has been fully vaccinated.[5] Perhaps more concerning is that the World Health Organization is monitoring no fewer than 10 SARS-CoV-2 variants of interest and concern.[6] So we have a long way to go before declaring victory on the health front. The economic recovery is also far from complete, with GDP levels well below pre-pandemic expectations in most countries, and like the health recovery, there is increasing divergence across regions. The adage that "no one is safe until everyone is safe" applies equally to the pandemic and global financial stability.

Second, borrowers, and therefore banks, are still heavily reliant on public support and forbearance measures. Bank loans benefiting from government guarantees or under moratorium stand at around 5% of total loans on average, with this number well into double digits in some jurisdictions.[7] The IMF recently estimated that unwinding these measures could lower banks' Common Equity Tier 1 ratios by about 50 basis points on average. In a similar vein, banks' liquidity risk profile continues to be largely subdued thanks to accommodative monetary policy and financial conditions. In many respects, the resilience of the banking system has yet to be truly tested.

Third, when we eventually do enter a true "post-pandemic" world, there is no doubt it will be one where the macro-financial landscape will be structurally more fragile than the pre-pandemic one. Even in a best-case scenario, where banks can safely navigate the choppy pandemic waters still ahead of us without incurring significant losses, the final destination will be characterised by much higher debt levels. Government debt-to-GDP ratios are at levels not seen since after the Second World War, while global household and corporate debt now hovers at almost 170% of GDP.[8] And loose financial conditions have seen some asset valuations reach record highs. We know from experience that conditions like these often precede and amplify shocks to the banking system. We have also been dealt a clear reminder of the importance of operational resilience and the risks posed by banks' reliance on outsourced providers.[9]

So how are banks managing these risks? One source of insight on this question is their provisioning practices. Throughout the past year we have seen a very wide range in these practices. In the initial phase of the pandemic, banks' provisioning as a percentage of their loans ranged from 1.6% to 540%, compared to a range of -1.6% to 180% at the end of 2019.[10] And, as of the last quarter of 2020, we have started seeing a bifurcation in practices, with some banks continuing to increase provisions while others have started to release billions of dollars' worth of provisions.

In principle, this could reflect genuine differences in views about the economic outlook. It could also arise from the varying extent to which banks are exposed to Covid-hit sectors and regions. Alternatively, it could also be the degree to which banks are making use of model overlays or "management adjustments" when determining provisions.

[5] Roser et al (2020). Data as at 16 May 2021.

[6] WHO (2021).

[7] IMF (2021c).

[8] IMF (2021b) and WEF (2020).

[9] BCBS (2021a).

[10] BIS (2021).

Of these possible explanations, the third is the most worrying. Admittedly, supervisors, including the Basel Committee, were quick to remind banks to use the flexibility and judgment built into provisioning standards. But one hopes that banks are remaining prudent in exercising this judgment. Given the wide range in numbers, it is hard not to wonder if some banks are being more aggressive than others in their modelling or use of judgment and overlays, or whether some banks are unduly influenced by the current loose financial conditions. And, very importantly, are banks' provisioning practices sufficiently transparent for market participants to understand and remain confident in them?

These questions bring back bad memories from our experience with the excessive variability in banks' internal regulatory capital models over the past decade. Timely and adequate provisioning, along with transparent and coherent reporting will remain key to banks preserving their position as "part of the solution and not part of the problem". Supervisors around the globe are paying very close attention to the range of bank practices on provisioning and the Committee is supporting this by conducting a deep dive on the topic.

More generally, the Committee will continue to monitor and assess Covid-19 risks and vulnerabilities in the global banking system. We have repeatedly stated that the Basel III capital and liquidity buffers can be used to absorb shocks and maintain lending to the real economy, and that supervisors will provide banks with sufficient time to restore them.[11] And we stand ready to pursue additional measures to mitigate risks if needed.

Basel III and the global level playing field

The pandemic reminded us of the imperative for global cooperation in tackling cross-border public policy issues. Like public health, financial stability is a global public good. The cross-border spillovers of financial distress can cause individual jurisdictions to underinvest in financial stability. An open global financial system therefore requires a global baseline of prudential standards. Just as monetary policy may face a "macroeconomic trilemma", one can think of a "financial trilemma" whereby any two of global financial stability, financial integration and national financial policies can be achieved, but not all three.[12] Global regulatory cooperation is therefore an imperative as long as we value the first two of those objectives.

This commitment to effective and close cooperation is one of the Basel Committee's core principles.[13] From the outset, we have retained a steadfast commitment to strengthening the regulation of banks worldwide and maintaining a close and constructive supervisory dialogue. While some have started to question the role and importance of international organisations in recent years, the Committee has confounded the doubters and completed the full set of Basel III reforms. Time and again, the Committee has shown its ability to work collectively and swiftly to strengthen the resilience of the global banking system.

At face value, banks have long touted the benefits of a global level playing field for prudential regulation. They regularly caution against regulatory fragmentation and stress the need for global responses to global problems. Yet, when push comes to shove, and its time for the standards to be implemented, this chorus call for global standards sometimes deteriorates into a lobby for national exemptions or adjustments.

11 See, for example, BCBS (2020b) and BCBS (2020c).

12 Schoenmaker (2011).

13 Hernández de Cos (2019).

I recently described the implementation of global standards as often being treated as a two-legged football game.[14] After the first "away" game in Basel, a second "home" game takes place, where banks and trade associations actively seek to renegotiate the global agreement. A litany of arguments is put forward as to the need for local adjustments to account for the idiosyncrasies of a bank's business model or the structure of a domestic market. This second leg, perhaps with the added "home advantage" benefit, has resulted in cases where the national implementation of Basel III is not fully compliant with the Basel framework.[15]

The away game is heating up here in Europe with an emerging narrative that banks cannot possibly be expected to support an economic recovery and implement the final set of Basel III reforms. Proponents of this argument call for either a further delay in implementation (over and above the already revised implementation timeline agreed by the Committee last year) and/or a customised variation on the global standards to tailor them to the "unique" circumstances of their banking systems.

Let me be clear: this is bank-induced market fragmentation. It is particularly surprising as it inevitably backfires when the resilience of a domestic banking system is called into question because of non-compliance with global standards. And surely the last year serves as a reminder that it is only healthy, well capitalised banks that can best support the real economy. The assertion that one must choose between strong banks and a strong economy is, plainly, false.

But if level playing field and financial stability benefits are not reason enough to support compliance with global prudential standards, consider the value of multilateralism and global cooperation in dealing with the risks in front of us. The last year has proven to be a catalyst in dealing with large global threats such as climate change. This has led to an explosion in activity by standard setters: recent stocktakes by the Committee and the Financial Stability Board suggest that the majority of our members are pursuing climate-related financial risk initiatives.[16] When I talk to banks these days, one of the recurring issues raised is the need for global harmonisation and consistency in such areas. Yet the current outlook presents the very real prospect of a fragmented landscape with layers of potentially conflicting definitions and standards. Obviously, this is something we all see the need to avoid.

So let me make the case that now is the time for banks to demonstrate that they value the benefits of globally agreed standards, and the clearest way to do that is to implement the standards that have already been agreed. Global standards are a public good that result from individual jurisdictions coming together to negotiate a compromise. The compromise is considered better than a customised solution because it levels the playing field and overcomes the collective action problem. But it only works if everyone implements it. If individual jurisdictions revert to customised solutions to adjust the compromise for their own benefit, the global good declines and the collective action problem is reignited.

The problems in front of us call for more global cooperation, not less. They call for more convergence of standards, not less. And they will require more cooperation and compromise, not less. The Basel III standards were finalised almost five years ago. As the Governors and Heads of Supervision recently reiterated, it is time to implement the final reforms in a full and consistent fashion and it is time to move on to new challenges.[17]

---

[14] Rogers (2021).

[15] BCBS (2020c).

[16] BCBS (2020a) and FSB (2020a).

[17] BCBS (2021b).

Banking for the future

Which brings me to my third and final question. What does the future hold for banks in an environment of ongoing digitalisation of finance, climate-related financial risks and the growth in non-bank financial intermediation (NBFI)?

These topics have been on our work programme for several years now, and the Committee and other global bodies have published a wide range of reports that evaluate some of their financial stability implications.[18] Our recently published work programme will build on this work, focusing as it does on proactively responding to structural changes in the banking sector.[19] This, in turn, requires a deeper understanding on how banks are responding to these dynamics.

Let me give just one example today. NBFI now accounts for almost half of the global financial system, a 20% increase since 2008.[20] Recent events – such as the market turmoil in March last year and a series of idiosyncratic stress events earlier this year – have further highlighted the wide range of direct and indirect channels of interconnectedness between banks and non-banks.

The growth in NBFI is taking place against a backdrop of intense technological progress in financial services. These developments have facilitated the provision of banking-type services by non-bank financial institutions, including by fintech and big tech companies. The ongoing digitalisation of finance is disrupting the financial system on multiple fronts as it is: (i) increasing customer expectations; (i) changing the processes and distributional channels through which services are offered; and (iii) changing the number and type of competitors.[21] Add to these structural shifts in banking the significant challenges that come with responding to the impact of climate risk on banks and I am reliably told that it is a tough time to be a bank!

Against this challenging backdrop, how should banks and bank supervisors respond? How do we strike the right balance between the benefits from technological innovation and the strategic and operational risks it introduces? How do we appropriately support the necessary transition to a less carbon-intensive future while avoiding potentially destabilising transitory impacts? Are risk management and governance practices keeping pace? And are the existing regulatory guardrails adequate when it comes to new entrants or new risks in the banking sector, or when it comes to banks' exposures to NBFI?

These are big challenges but it strikes me that we do not have a decade to fix these challenges, as we did in dealing with the last crisis.

Conclusion

I have discussed some of the main issues that are on the minds of the Committee and its members these days. And I have shared my view that the banking system is at a critical juncture in terms of the next phases and fallout of Covid-19, its commitment to global standards and a level-playing field, and the challenges that lie ahead.

[18] See, for example, BCBS (2018, 2021c and 2021d).

[19] BCBS (2021e).

[20] FSB (2020b).

[21] Restoy (2021).

References

Bank for International Settlements (2021): *BIS Quarterly Review*, March.

Basel Committee on Banking Supervision (BCBS) (2011): *Basel III: a global regulatory framework for more resilient banks and banking systems*, June.

——— (2017): *Basel III: finalising post-crisis reforms*, December.

——— (2018): *Sound Practices: Implications of fintech developments for banks and bank supervisors*, February.

——— *(2020a): Climate-related financial risks: a survey on current initiatives, April.*

——— *(2020b): "Basel Committee meets; discusses impact of Covid-19; reiterates guidance on buffers", press release, 17 June.*

——— (2020c): "Governors and Heads of Supervision commit to ongoing coordinated approach to mitigate Covid-19 risks to the global banking system and endorse future direction of Basel Committee work", press release, 30 November.

——— (2021a): *Principles for operational resilience*, March.

——— (2021b): "Governors and Heads of Supervision meet to endorse strategic priorities and work programme of Basel Committee and discuss global initiatives on non-bank financial intermediation", press release, 31 March.

——— (2021c): *Climate-related risk drivers and their transmission channels*, April.

——— (2021d): *Climate-related financial risks – measurement methodologies*, April.

——— (2021e): *Basel Committee work programme and strategic priorities for 2021/22*, April.

Borio, C, M Farag and N Tarashev (2020): "Post-crisis international financial regulatory reforms: a primer", *BIS Working Papers*, no 859, April.

Financial Stability Board (2020a): *Stocktake of financial authorities' experience in including physical and transition climate risks as part of their financial stability monitoring*, July.

——— (2020b): *Global monitoring report on non-bank financial intermediation*, December.

Hernández de Cos, P (2019): "The future path of the Basel Committee: some guiding principles", speech at the Institute for International Finance Annual Membership Meeting, Washington DC, 17 October.

——— (2020): "Covid-19 and banking supervision: where do we go from here?", speech at the 21st International Conference of Banking Supervisors, 19 October.

——— (2021): "Crossing the Basel III implementation line", speech at the Eurofi High-Level Virtual Seminar, 15 April.

International Monetary Fund (2021a): *Fiscal Monitor Database of Country Fiscal Measures in Response to the Covid-19 Pandemic,* April.

——— (2021b): *World Economic Outlook,* April.

——— (2021c): *Global Financial Stability Report*, April.

Restoy, F (2021): "Fintech regulation: how to achieve a level playing field", *FSI Occasional Papers*, no 17, February.

About the author

Carolyn Rogers *was appointed to the Secretary General role for the Basel Committee for Banking Supervision in March of 2019 and took up her duties in August of 2019. She has 20 years of executive management experience in the financial services industry, having worked in both the public and the private sector. Prior to joining the Committee Ms Rogers was the Assistant Superintendent of Regulation at the Office of the Superintendent of Financial Institutions (OSFI) in Canada and served as OSFI's representative on the Basel Committee. Before joining OSFI, Ms Rogers served as Superintendent and Chief Executive Officer of the Financial Institutions Commission (FICOM), an integrated financial regulator for the Province of British Columbia in Canada. Before entering financial regulation Ms Rogers worked in various roles in the private sector, including as Chief Financial Officer and Chief Executive Officer of a private company. She also spent time in the financial services sector at several co-operative organizations and at a major Canadian bank. Ms Rogers is a Chartered Professional Accountant (CPA), Certified Management Accountant (CMA) and holds a Bachelor of Arts and a Master of Business Administration (MBA) from Queen's University in Canada, and has completed the Institute of Corporate Directors program.*

SUERF Publications

Find more **SUERF Policy Briefs** and **Policy Notes** at www.suerf.org/policynotes

SUERF
The European Money and Finance Forum

SUERF is a network association of central bankers and regulators, academics, and practitioners in the financial sector. The focus of the association is on the analysis, discussion and understanding of financial markets and institutions, the monetary economy, the conduct of regulation, supervision and monetary policy.

SUERF's events and publications provide a unique European network for the analysis and discussion of these and related issues.

SUERF Policy Briefs (SPBs) serve to promote SUERF Members' economic views and research findings as well as economic policy-oriented analyses. They address topical issues and propose solutions to current economic and financial challenges. SPBs serve to increase the international visibility of SUERF Members' analyses and research.

The views expressed are those of the author(s) and not necessarily those of the institution(s) the author(s) is/are affiliated with.

SUERF Secretariat
c/o OeNB
Otto-Wagner-Platz 3
A-1090 Vienna, Austria
Phone: +43-1-40420-7206
www.suerf.org • suerf@oenb.at