Kilvar Kessleri Euroopa panganduse instituudi poliitikakonverentsi kõne (inglise keeles)

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Thank you for inviting me to the 3rd EBI Policy Conference to speak. I think this theme of “Recovery and Growth in a Post-Pandemic EU” is very acute. It is appropriate to reflect back on what was good and what went wrong, if anything went wrong at all. And to look forward to the future.

Before we delve further into today's topic, a couple of words on how I like to operate as a financial supervisor. Prior to being elected as chairman of Finantsinspektsioon in 2014, I was responsible for securities markets and enforcement. While I was doing that we created precedents with the first ever cases for both insider trading and market manipulation. We made the banks compensate the losses suffered by investors because of the breach of the conflict of interest rules, setting another series of precedents in Estonia during the financial crises in 2008. In the years since 2014, I and my new team closed the toxic non-resident portfolio of Danske in Estonia already in 2015, which was more widely discussed from 2018 without due understanding issue at hand is historic. We requested that the ECB-SSM terminate the licence of Versobank, a small monoliner concentrating on non-residents. The license got terminated in 2018 for serious AML breaches, again setting a precedent, this time for the ECB. I like timely, firm and swift supervisory decisions. As Elvis Presley sang – "A little less conversation, a little more action, please."

My presentation will take 10 minutes or so. I will discuss **Banks in and after the pandemic crisis**. It is more of a local view, but contains elements that are applicable to the rest of Europe. First I will discuss how effective the Covid measures have been and the lessons that we have learned from them. Then I will consider the risk outlook going forward. I will conclude with the challenges of digitalisation. I will not talk about the green agenda: this is large important topic needs to be dealt with separately.

The banks that are active in the Baltic area weathered the Covid crisis well. Aside from the fiscal support of governments and the policies of central banks, I think there were two elements that created this result. These two crucial elements were the sufficient capital buffers that the banks held from the earlier good days. Second, a moratorium on private loans that was agreed by the banking industry using the EBA model. By the way, the release of the macroprudential buffers in Estonia played only a signalling role.

The EBA framework for the moratorium was excellent. It contained sufficient incentives in the form of certain capital relief for banks that allowed them to grant the moratorium. Equally, it built a transparent and uniform framework for giving relief to different classes of debtors. We at Finantsinspektsioon of Estonia are both prudential supervisors and conduct of business supervisors. So we enjoyed this solution to the max.

Many clients used their right to the payment relief options. The coverage of the loan moratoriums peaked at over 11% of the total loan portfolio, but today it is just 1.8%. The credit quality has not suffered, and it is still strong despite the discontinuation of the moratorium. It seems that the payment relief measures worked as a bridge over the difficult times. Clients have now been able to return to their normal payment schedules.

The Baltic banks had accumulated quite substantial profits before the Covid pandemic. The capital buffers in Estonia were large enough to withstand losses with plenty of room to spare. Accumulated profits were on average 2.1 times larger than the regulatory buffers. This meant it was of the utmost importance to block dividend distributions so that these buffers would be maintained. We were successful enough in this to convince our friends at the ECB to follow the same path. Initially the ECB was a bit slower to move into crisis mode, but it got on track pretty fast.

The result, however, was that the Baltic banks did not use their capital and liquidity buffers, including those that were released by supervisory relief measures for the pandemic. Interestingly enough, they continued to operate profitably. The banks in Estonia continued to finance the economy. The credit growth in 2020, the first Covid year, was 2%. In the first half of 2021, credit growth accelerated to 6% per year. Of course, there have been some losers, such as tourism, restaurants and the hospitality industry. But it seems there has been a fundamental shift in Estonia's economy towards IT and digital services. Even during the crisis there were segments of the economy like information and communications that were close to booming. Before returning to digitalisation topic, let me draw a couple of intermediate conclusions.

For me, restricting dividends in good time and establishing a framework for the moratoriums proved to be practical and successful moves. The very quick and effective cooperation between European supervisors and within the SSM, with which I was more closely involved, was unprecedented. I think this is something for which we supervisors can give each other a pat on the back.

What worried me was how quickly regulators changed the capital requirements regulation. Even though I understand that nobody really knew in the first days of the Covid crisis how serious it would all become, there was a big question mark for me over changing, basically overnight, rules that had been so carefully crafted and heatedly debated. Did we lose an opportunity there, did we give steroids to these banks that were not living nor dead, did we seize the moment for purposes other than fighting the Covid crisis? Or on the contrary, did we overregulate initially, and if so, then are there some other areas where we have also gone too far? I can see areas where smaller member states and their small market participants are suffering because of red tape.

Now, back to today. Given the successful roll-out of vaccination in many countries and the improved economic outlook, any sudden rise in NPLs is less likely. But there remain significant pockets of vulnerability like commercial real estate, construction, and leveraged financial products.

While the majority of loan moratoriums have expired, there are still concentrations of loans with outstanding moratoriums. These might be of weaker quality than loans that have already exited the moratorium. The high level of Stage 2 loans and their lagging reclassification to the status of NPL and forborne may also indicate that some credit risk may still be hidden by the fiscal measures.

The credit risk management processes of the banks came under scrutiny during the Covid crisis. Gaps were revealed in the credit risk management, classification and provisioning practices in some banks, such as inadequate unlikely to pay assessments, IFRS9 staging and provisioning.

In the market risk area there is an increased risk of a significant correction in market prices, including in the sovereign spreads.

The profitability of the business model of the euro area banks has improved. But the structural weaknesses related to the continuingly depressed interest margins, overcapacity, inelastic costs and difficulties in delivering on the digital transformation remain. The low profitability is one of the key drivers of risk to the resilience of the banking sector. Costs of EU banks are too high, income too low, C/I ration being around 65% on average.

And so to the topic of digital. The Estonian banks were already very digital on the client side long before the Covid crisis. More than 92% of all payments by private individuals are initiated in e-channels, and 87% of those payments travel instantly. The review of Estonian digitalisation by the Commission found the penetration of digital banking to be one of the highest in EU. Our third largest bank considers that they have too many branches – but they have only one bricks and mortar branch. C/I ratio in Estonian banks being below 50% in average.

During the peak of the pandemic, up to 70% of all bank employees worked from home. This was without any significant setbacks for operations. However the remote work coincided with a significant increase in cyber-attacks. The banks were able to fend off these attacks successfully this time. Covid has certainly injected a lot of momentum into digitalisation. This can and must be used to make the leap to the digital transformation.

Quite recently we had a strategy discussion at the SSM. By default, credit risk and market risk were mentioned as key areas interest. Interestingly though, the discussion evolved around digitalisation and the related risks. Everybody understood that this is something that needs to be addressed soon and worked on.

But I am afraid that we as supervisors do not yet understand the extent of digitalisation and how it changes the level of automated activities in the financial sector. How, for example, should we monitor risks in the public blockchain? Have banks developed the capacity and sufficient know-how that they need if they are planning to use such technology? I am afraid that if we do not act right now, it will create challenges in implementation for supervisors in future. Skills and know-how in supervising ICT have become essential and the relative importance of ICT in supervisory activities and resources, including staffing, must grow. For example, currently we have 4% of total staff as IT auditors, but in future we would like to increase it over 10%. I see that in addition to financial auditors, accountants and lawyers, there will be fourth segment – that is ICT experts - in every financial supervisor.

To summarise, the impact of Covid was not as severe as was feared at the beginning, or has not been so yet. Not least because of the well-coordinated supervisory efforts of dividend restrictions and moratoriums, and the extensive state support measures. The support measures seem to have yielded the desired outcome of providing a bridge over the deepest parts of the crisis. Nevertheless, the challenges of asset quality and the focus on those challenges should continue in the nearest future. The crisis revealed gaps and deficiencies in credit risk and data management. It is essential for resilience that the banks deal with those gaps.

The Covid crisis gave a unique impetus to digitalisation. Covid did more to convince traditional banks to digitalise than any supervisor could ever do. However the challenges related to the digital transformation must now be addressed correctly. The importance of ICT in supervisory activities and resources must grow. Digitalisation must not occur only in supervised entities, but the supervisory processes must also become more automated and must use advanced data processing technologies.

But once again - “A little less conversation, a little more action, please.”

Kilvar Kessler

[**Teavita mind, kui sisu muutub**]()