EU financial regulators warn of an expected deterioration of asset quality

Macroeconomic conditions improved in the second half of 2020, supported by ongoing fiscal and monetary policy efforts, but the resurgence of the COVID-19 pandemic since the last quarter of 2020 has led to increasing economic uncertainty. The start of the rollout of vaccinations provides a crucial anchor for medium-term expectations, but insufficient production capacities, delays in deliveries as well as risks related to mutations of the virus are weighing heavily on short-term recovery prospects.

Macroeconomic uncertainty was generally not reflected in asset valuations and market volatility which have recovered to pre-crisis levels, highlighting a continued risk of decoupling of valuations from economic fundamentals.

In light of these risks and uncertainties, the ESAs advise, national competent authorities, financial institutions and market participants to take the following policy actions:

- **Prepare for an expected deterioration of asset quality**: banks should adjust provisioning models to adequately address the impact of the economic shock of the pandemic and to ensure a timely recognition of adequate levels of provisions. They should engage to restructure over indebted but viable exposure efficiently. To supervisors, banks' provisioning policies should continue to be a point of particular attention;
- **Continue to develop further actions to accommodate a "low-for-long" interest rate environment and its risks**: while low interest rates are important to support economic activity, they negatively impact banks' interest income and remain the main risk for the life insurance and pension fund sector. For insurers, it is important that the regulatory framework also reflects the steep fall in interest rates experienced in recent years and the existence of negative interest rates. Financial institutions should also continue to monitor, and be prepared for, changes in interest rates, especially in light of the recent upward shifts of long-term interest rates and the consequent concerns about re-emerging inflationary pressures;
- **Ensure sound lending practices and adequate pricing of risks**: banks should continue to make thorough risk assessments to ensure that lending remains viable in the future, and this should be closely monitored by supervisors. Banks should continue to make thorough risk assessments to ensure that lending remains viable, including after public support measures such as loan moratoria and public guarantee schemes will expire;
- **Follow conservative policies on dividends and share buy-backs**: any distributions should not exceed thresholds of prudency; and
- **Investment funds should further enhance their preparedness in the face**

of potential increases in redemptions and valuation shocks: to this end the alignment of fund investment strategy, liquidity profile and redemption policy should be supervised, as well as funds' liquidity risk assessment and valuation processes in a context of valuation uncertainty.

Background

The three ESAs cooperate regularly and closely to ensure consistency in their practices. In particular, the Joint Committee works in the areas of supervision of financial conglomerates, accounting and auditing, micro-prudential analyses of cross-sectoral developments, risks and vulnerabilities for financial stability, retail investment products and measures combating money laundering. In addition, the Joint Committee also plays an important role in the exchange of information with the European Systemic Risk Board.

The Joint Committee is the forum for cooperation between the European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA), collectively known as the ESAs.