EBA - The EU Regulatory Framework for Market Risk and Prudent Valuation: are the Rules too Procyclical?

Highlights

- Following the Covid-19 pandemic, financial market volatility spiked in February 2020 and has remained relatively high until the end of 2020. The 2022 global energy crisis consecutive to Russia’s aggression against Ukraine has triggered another period of heightened volatility in February 2022, particularly in the energy markets. The Covid-19 pandemic appears to be the second largest crisis after the global financial crisis in 2008, while the 2022 global energy crisis was much milder.

- From a prudential perspective, capital requirements linked to traded risks have generally increased during these stress periods. In particular, according to an analysis on 72 EU banks, capital requirements for market risk have increased on average by 16.5% in the Q1-2020 (COVID-19 pandemic) and by 16.3% in Q1-2022 (2022 global energy crisis).

- This sparked market participants and banking associations to call for regulatory action to smooth the procyclical impact of the capital requirement framework. Whether during a period of stress, capital requirements should increase or not has been a long-standing debate among the regulatory community. Among regulators, the debate became particularly prominent during these last two crises. The regulatory and supervisory community adopted several temporary relief measures following the Covid-19 pandemic, including some that aimed at reducing the procyclical components embedded in the regulatory framework. Instead, similar measures were not introduced in the context of the 2022 global energy crisis. Both experiences have therefore raised significant questions about the degree of procyclicality in the current framework, and about the circumstances under which a strong regulatory response, like the one adopted during the Covid-19 period, is warranted.

- In this EBA paper, it has been analyzed the impact of the two crises on the capital requirements for market risk and the requirements linked to prudent valuation, with the objective of assessing the different approaches taken by regulators in response to these crises. To that end, EBA first defines metrics to assess the intensity of the capital requirements, then assesses how the intensity in the capital requirements varies with the volatility in financial markets and based on the trends observed in those metrics EBA put into context the regulatory responses. The EBA analyses is based on supervisory data on market risk and prudent valuation for the biggest EU banks between Q4-2017 and Q4-2022. In this paper EBA, firstly, wants to bring evidence on the dynamics of the regulatory framework in a crisis event by doing an ex-post assessment: this can serve as a basis for future policy discussions in case of another crisis event materializing. Second, EBA wants to raise supervisory awareness on the functioning of the market risk and prudent valuation frameworks given the materiality of those two frameworks for some important players in the EU.