Threats to EU financial stability amidst the 2020 pandemic crisis[1]

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1. The robustness of the EU banking system before the current pandemic crisis

(1) Unlike in the case of the 2007-2009 Global Financial Crisis (**GFC**),[2] the current COVID-19 pandemic (hereinafter **'pandemic crisis'**) was not caused by failings of the financial sector; it was rather caused by a random, almost completely unpredictable (black swan, *cygnus atratus*) event. In addition, the first-round focus is on the rescue of companies in the economy's real sector; banks, which were at the centre of the GFC, are currently, on a global scale, much better capitalised and with stronger liquidity, while financial stability has also been enhanced overall.

(2) The relatively better financial conditions of EU banks (credit institutions) in the period just before the outbreak of the pandemic crisis can be attributed, *inter alia*, to two main factors:

The *first* is the so-called **"Basel III impact"**, namely the fact that credit institutions benefited, in terms of both capital and liquidity adequacy, from having implemented macro-prudential buffers, which were introduced, at global level, by the 2010 Basel Committee on Banking Supervision's **'Basel III regulatory framework'**.[3] These are currently available to allow them to effectively contribute to the short- and longer-term financing of economic activity and recovery in the EU, and complement the higher quality of capital, which has also been a by-product of the Basel III regulatory framework, as applied in the EU by the micro- and macro-prudential pillars of the 2013 single rulebook, namely the capital requirements Regulation and Directive (**CRR** and **CRD IV**, as currently in force[4]).

[1] This article is an extended and updated version of the author's contribution in the weekend edition No 24 of the EU LAW LIVE of 3 July 2020 (available at: https://eulawlive.com/weekend-edition/weekend-edition-no24). The cut-off date for information included therein is **5 July 2020**.

[2] For a brief overview of the causes of that crisis, see **Gortsos, Ch. V. (2012)**: *Fundamentals of Public International Financial Law: International Banking Law within the System of Public International Financial Law*, Schriften des Europa-Instituts der Universität des Saarlandes – Rechtswissenschaft, Nomos Verlag, Baden-Baden, pp. 127-129, with extensive further references out of vast existing literature.

[3] The framework consists of three Reports of the Basel Committee: "Basel III: A global regulatory framework for more resilient banks and banking systems" (available at: https://www.bis.org/publ/bcbs189.htm), "Basel III: The Liquidity Coverage Ratio [**LCR**] and liquidity risk monitoring tools" (available at: https://www.bis.org/publ/bcbs238.htm), and "Basel III: The net stable funding ratio [**NSFR**]" (available at: https://www.bis.org/publ/ bcbs295.htm). On this framework, in its original version of 2010, see **Gortsos (2012)**, *op. cit*., pp. 254-281.

[4] **Regulation (EU) No 575/2013** of the European Parliament and of the Council of 26 June 2013 "on prudential requirements for credit institutions and investment firms (…)" (OJ L 176, 27.6.2013, pp. 1-337) and **Directive 2013/36/EU** of the same institutions and of the same date "on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (…)" (OJ L 176, 27.6.2013, pp. 338-436).

The *second* factor is the improvement in the quality of micro-prudential banking supervision, carried out since 2014, for the euro area Member States, by the European Central Bank (**ECB**) for significant credit institutions and by national competent (supervisory) authorities (**NCAs**) for less significant credit institutions within the Single Supervisory Mechanism (**SSM**). The SSM was established in 2013 by virtue of the SSM Regulation (**SSMR**)[5] and constitutes the first pillar of the Banking Union (designed as a response to the fiscal crisis in the eurozone[6]). As illustratively noted in the Report drawn up on 25 February 2009 by the *de Larosière* High-Level Group,[7] the financial system of several states were not exposed (at least primarily), or were less significantly exposed, to the GFS not only because they were equipped with a strong institutional and regulatory framework, but also because micro-prudential supervision of their banking system (sector) was, admittedly, suitable; and that was not the case in the EU.

(3) In addition, since 2014, the EU solvency crisis management framework has also been enhanced by the (new) banking resolution framework laid down in the Bank Recovery and Resolution Directive (**BRRD**, as currently in force,[8] the content of which was heavily influenced by the international financial standards developed by the Financial Stability Board (**FSB**).[9] This framework was (globally) designed to effectively address the "too big to (be left to) fail problem", in relation to which the recent (28 June 2020) **FSB consultation Report** "*Evaluation of the effects of too-big-to-fail reforms*"[10] stresses that these reforms made banks, globally, more resilient and resolvable, but noted that gaps still need to be addressed.

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[5] **Council Regulation (EU) No 1024/2013** of 15 October 2013 "conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions", OJ L 287, 29.10.2013, pp. 63-89.

[6] On the causes of this crisis and the related policy responses, see indicatively, out of a vast existing literature, **Zimmermann, H. (2015)**: The deep roots of the government debt crisis, *The Journal of Financial Perspectives*, EY Global Financial Services Institute, March, Volume 3, Issue 1, pp. 33-42 and **Hadjiemmanuil, Ch. (2019)**: *The Euro Area Crisis, 2008-2018*, in Amtenbrink, F. and Ch. Hermann (2019, editors): *Oxford Handbook on the EU Law of Economic and Monetary Union*, Part 8, 8.4., Oxford University Press, Oxford (forthcoming), LSE Law, Society and Economy Working Papers 12/2019, also available at: https://ssrn.com/abstract=3413000

[7] For an overview of this Report (available at: https://ec.europa.eu/commission_barroso/president/pdf/statement_20090225_en.pdf), see **Ferrarini, G. and F. Chiodini (2009)**: Regulating cross-border banks in Europe: a comment on the de Larosière report and a modest proposal, *Capital Markets Law Journal*, Vol. 4, Oxford University Press, pp. 123-140 and **Louis J.-V. (2010)**: The implementation of the Larosière report: a progress report, in Giovanoli, M. and D. Devos (2010, editors): *International Monetary and Financial Law: The Global Crisis*, Oxford University Press, Oxford – New York, Chapter 7, pp. 146-176.

[8] **Directive 2014/59/EU** of the European Parliament and of the Council of 15 May 2014 "establishing a framework for the recovery and resolution of credit institutions and investment firms (…)", OJ L 173, 12.6.2014, pp. 190-348. This was substantially amended by **Directive (EU) 2019/879** of the same institutions of 20 May 2019 "(…) on loss-absorbing and recapitalisation capacity of credit institutions and investment firms (…)" (**BRRD II**), OJ 150, 7.6.2019, pp. 296-344.

[9] See in this respect the FSB's "Key Attributes of Effective Resolution Regimes for Financial Institutions", of November 2011 (available at: https://www.financialstabilityboard.org/publications/r_111104cc.htm) and currently in force as revised in October 2014 (available at: https://www.financialstabilityboard.org/2014/10/r_141015).

[10] Available at: https://www.fsb.org/2020/06/evaluation-of-the-effects-of-too-big-to-fail-reforms-consultation-report.

For the euro area in particular, the Single Resolution Mechanism Regulation (**SRMR**) is also applicable;[11] it forms the basis for the second pillar of the Banking Union, consisting of the Single Resolution Mechanism (**SRM**) and the Single Resolution Fund (**SRF**). Even though resolution action has been taken only in a few (albeit rather important) cases in the EU, the progress made on resolution planning, in order to make credit institutions resolvable, and the (related) build-up of minimum requirements (for own funds and) eligible liabilities (**MREL**) are considered as important elements in order to maintain a strong banking system and to preserve financial stability. The resolution planning framework will be further enhanced as of 2021 upon the application of the revised rules laid down in the legislative acts which revised (in 2019) the initial ones (BRRD II and SRMR II).

(4) Overall, one can reasonable argue that, just before the outbreak of the pandemic crisis, the EU banking system was quite robust. *Inter alia*, according to the quarterly Risk Dashboard of the European Banking Authority (**EBA**)[12] of 14 April 2020, [13] which covers data of the 4th quarter of 2019 and summarises the main risks and vulnerabilities in the EU banking system ahead of the crisis, EU credit institutions' capital ratios and asset quality have (on average) constantly improved (even though return on equity has worsened). As recently noted by Andrea Enria, Chair of the ECB Supervisory Board: "*Unlike in the 2008 financial crisis, banks are not the source of the problem this time. But we need to ensure that they can be part of the solution.*"[14]

2. A brief overview of EU economic policy responses to the crisis and the role of the ECB

(1) Immediately after the outbreak of the crisis, the EU developed a (rather) consistent **strategy**, which has taken into account the spill-overs and interlinkages between EU economies and the need to preserve confidence and stability. The measures taken, in order to deal with health emergency needs, support economic activity and employment, preserve monetary and financial stability and prepare the ground for recovery, contain a combination of government fiscal *stimuli* (with extensive resort to the principle of solidarity), emergency liquidity and monetary policy measures and measures relating to financial stability.[15]

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[11] **Regulation (EU) No 806/2014** of the European Parliament and of the Council of 15 July 2014 "establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund (…)", OJ L 225, 30.7.2014, pp. 1-90. This is currently in force as substantially amended by **Regulation (EU) 2019/877** of the same institutions of 20 May 2019 "(…) as regards loss-absorbing and recapitalisation capacity for credit institutions and investment firms" (**SRMR II**), OJ 150, 7.6.2019, pp. 226-252.

[12] This agency, a child of the above-mentioned 2009 *de Larosière* Report and an integral part of the European System of Financial Supervision (**ESFS**), was established by virtue of **Regulation (EU) No 1093/2010** of the European Parliament and of the Council of 24 November 2010 "establishing a European Supervisory Authority (European Banking Authority) (…)", OJ L 331, 15.12.2010, pp. 12-47.

[13] Available at: https://eba.europa.eu/eu-banks-sail-through-corona-crisis-sound-capital-ratios.

[14] See at: https://www.bankingsupervision.europa.eu/press/interviews/date/2020/html/ssm.in200623~e668f871fa.en.html.

[15] For a general overview (as of 10 May 2020), see **Busch, D. (2020)**: "Is the European Union going to help us overcome the COVID-19 crisis?", in Gortsos, Ch.V. and W.G. Ringe (editors): *Pandemic Crisis and Financial Stability*, European Banking Institute (EBI), e-book, no. 1, pp. 3-42, available at: https://ssrn.com/abstract=3607930. On the fiscal stimuli (as of 19 May), see **Hadjiemmanuil, Ch. (2020)**: "European economic governance and the pandemic: Fiscal crisis management under a flawed policy

(2) In this respect the role of the ECB in the euro area has been predominant. In particular:

First, in its capacity as a monetary authority within the Eurosystem, the ECB has adopted several bold monetary policy measures (admittedly, very close to those taken by major central banks all over the world[16]), taking into account its primary objective of price stability, the instruments at its disposal and the limitations set by the TFEU (for example, the monetary financing of fiscal policy (by the purchase of government bills and bonds in the primary market) is prohibited by virtue of **Article 123**), by applying both its conventional (interest rate) and unconventional (mainly, balance-sheet) policies.[17]

Second, since the prudential regulatory framework governing credit institutions (CRR and CRD IV) provides certain elements of 'flexibility', and by considering that making full use of this flexibility is essential to overcome the financing pressures faced by firms and households, the ECB, as a banking supervisory authority, within the SSM, and complemented by the EBA, adopted specific supervisory measures to ensure that credit institutions have the capacity to foster credit flows to households and businesses in a flexible way during (at least the initial phase of) the pandemic crisis.[18] The financial stability-related measures taken by the ECB within the SSM include those relating to the relaxation of some macro-prudential buffers and the adaptation of the composition of specific capital requirements, the reduction of credit institutions' capital requirements for market risk (in order to maintain their ability to provide market liquidity and continue their market-making activities), the application of flexibility regarding, mainly, the treatment of non-performing loans (**NPLs**), and its Recommendation "on dividend distributions during the COVID-19 pandemic (…) (**ECB/2020/19**)"[19] to credit institutions (on the basis of the "comply or explain principle") to temporarily ban the payment of dividends by credit institutions.[20]

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process", in Gortsos, Ch.V. and W.G. Ringe (editors): *Pandemic Crisis and Financial Stability*, *op. cit.*, no. 6, pp. 175-243

[16] See **Carstens, Aug. (2020)**: *Countering Covid-19: The nature of central banks' policy response*, Opening remarks at the UBS High-level Discussion on the Economic and Monetary Policy Outlook, Zurich, 27 May (available at: https://www.bis.org/speeches/sp200527.htm), pp. 2-4.

[17] For a detailed presentation, see **Gortsos (2020c)**: "The response of the European Central Bank to the current pandemic crisis: monetary policy and prudential banking supervision decisions", *European Company and Financial Law Review*, 2020, no. 3 (forthcoming), Section B. For an overview of the framework governing the ECB's conventional monetary policy measures ("general framework" in its terminology) (just) before the pandemic crisis, see **Gortsos, Ch.V. (2020a)**, *European Central Banking Law – The Role of the European Central Bank and National Central Banks under European Law*, Palgrave Macmillan Studies in Banking and Financial Institutions, Palgrave Macmillan, Cham – Switzerland, pp. 286-297; on unconventional monetary policy measures and the framework governing such ECB monetary policy measures (the "temporary framework" in its terminology), see *ibid.*, pp. 12-14 and 297-300, respectively.

[18] For a more detailed presentation, see **Joosen, B. (2020)**: "Balancing macro- and micro-prudential powers in the SSM during the COVID-19 crisis", in Gortsos, Ch.V. and W.G. Ringe (editors): *Pandemic Crisis and Financial Stability*, *op. cit.*, no. 10, pp. 339-360 and **Gortsos (2020c)**, *op. cit.*, Section C. Equivalent initiatives were undertaken at global level by the Basel Committee in accordance with its Report of 3 April 2020 "Measures to reflect the impact of COVID-19" (available at: https://www.bis.org/bcbs/publ/d498.htm).

[19] OJ C 102I, 30.3.2020, pp. 1-2.

[20] See also the **Recommendation** of the ESRB of 27 May 2020 on restriction of distributions during the COVID-19 pandemic (**ESRB/2020/7**, OJ C 212, 26.6.2020, pp. 1-6).

In addition, the ECB fully supported, in its Opinion of 20 May,[21] the adoption of **Regulation (EU) 2020/873** of the European Parliament and of the Council of 24 June 2020 amending the CRR and the CRR II[22] "as regards certain adjustments in response to the COVID-19 pandemic".[23]

Finally, noteworthy is also the contribution of the European Systemic Risk Board (**ESRB**),[24] in the field of financial macro-prudential oversight, in order to address pandemic-related systemic vulnerabilities. Since the ECB is heavily involved in the ESRB's operation and the decision-making process, this is yet another field in which the ECB's contribution is significant as well.[25]

(3) It is also noted that, with a view to achieving the objective of preserving financial stability at euro area level, while also allowing flexibility in the application of the resolution framework amidst the crisis, the Chair of the Single Resolution Board (**SRB**), Elke König, made three targeted interventions in relation to credit institutions' resolution planning.[26] In addition, in relation to capital markets regulation, the European Securities and Markets Authority (**ESMA**)[27] has also taken a series of specific measures,[28] such as guidance on accounting implications for listed companies, measures relating to short selling bans and the maintenance of conduct of business obligations under the Markets in Financial Instruments Directive (**MiFID II**,[29] as currently in force).

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[21] Opinion of the ECB "on amendments to the Union prudential framework in response to the COVID-19 pandemic (CON/2020/16)" 2020/C 180/04, OJ C 180, 29.5.2020, pp. 4-9.

[22] **Regulation (EU) 2019/876** of the European Parliament and of the Council of 7 June 2019 "amending Regulation (EU) No 575/2013 [CRR] as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements (…), OJ 150, 7.6.2019, pp. 1-225.

[23] OJ L 204, 26.6.2020, pp. 4-17. On the content of this Regulation, see **Wojcik, K.-Ph. (2020)**: "The EU's Response to the COVID-19 Pandemic in the Field of EU Banking Regulation", *EU LAW LIVE*, edition No 24, 3 July, pp. 19-21.

[24] The ESRB, another integral part of the ESFS, was established by virtue of **Regulation (EU) No 1092/2010** of the European Parliament and of the Council of 24 November 2010 "on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board", OJ L 331, 15.12.2010, pp. 1-11.

[25] On the role of the ECB in the ESRB, see **Gortsos (2020a)**, *op. cit.*, pp. 371-373.

[26] Available, respectively at: https://srb.europa.eu/en/node/965, https://srb.europa.eu/en/node/966 and https://srb.europa.eu/en/node/967.

[27] The ESMA is also an integral part of the ESFS and was established by virtue of **Regulation (EU) No 1095/2010** of the European Parliament and of the Council of 24 November 2010 "establishing a European Supervisory Authority (European Securities and Markets Authority)", OJ L 331, 15.12.2010, pp. 84-119.

[28] On this aspect, see **Moloney, N, and Conac, P.-H. (2020)**: "EU Financial Markets and the Covid-19 Crisis", *European Company and Financial Law Review*, 2020, no. 3 (forthcoming), and **Enriques, L. and M. Pagano (2020)**: "Emergency measures for equity trading: the case against short-selling and stock exchange shutdowns", in Gortsos, Ch.V. and W.G. Ringe (editors): *Pandemic Crisis and Financial Stability*, *op. cit.*, no. 13, pp. 413-428.

[29] **Directive 2014/65/EU** of the European Parliament and of the Council of 15 May 2014 "on markets in financial instruments (…)", OJ L 173, 12.6.2014, pp. 349-496.

3. The challenges ahead

(1) The exit strategy from the ECB's monetary policy measures, which are designed as temporary, will be dictated by the duration of the crisis and macroeconomic developments over the coming months (even though accurate assessments cannot obviously be made as yet[30]). On the other hand, the exit strategy in the case of prudential regulation is much more complicated, even though the measures adopted are designed as temporary as well. On 6 and 27 May 2020, respectively, the ESRB's General Board took two sets of actions in response to the coronavirus crisis, addressing five major financial stability issues: financial system implications of fiscal measures taken to protect the real sector of the economy; market illiquidity and implications for asset managers and insurers, as well as the impact of large-scale downgrades of corporate bonds on markets and entities across the financial system (as a by-product of increased volatility in capital markets and 'flight to quality' reactions); system-wide restraints on dividend payments, share buybacks and other pay-outs; and liquidity risks arising from margin calls.[31]

(2) Nevertheless, the most acute problem is (yet again) the expected increase in the ratio of credit institutions' NPLs (and more broadly non-performing exposures (**NPEs**)), which – as already mentioned – on average, significantly decreased during the years following the GFC and the euro area fiscal crisis. NPLs are expected to increase across the board (and in certain cases exponentially) in almost all Member States (including within the euro area) both in relation to credits and loans granted to firms and households before the outbreak of the pandemic crisis, to the extent that these will be affected by the severe slowdown of the economy, as well as to credit and loans that are granted during the crisis (albeit in certain cases of ailing businesses covered by State guarantees).

The author has defended the view that the flexibility currently provided to credit institutions to prolong the periods for the classification of loans as non-performing is justified in terms of supporting the financing of the fragile real sector of the economy at this first phase of the pandemic crisis. It, nevertheless, entails the risk of accumulation of problems after the lapse of the 'moratorium' period, the extent of which will vary both among Member States (depending on the depth and the duration of the current and upcoming economic recession) and among credit institutions in each Member State (depending on the composition of their loan portfolio, mainly in relation to exposures on individuals and companies in sectors most severely affected).[32]

(3) As already noted, the duration of the current pandemic crisis and its precise economic impact cannot be accurately determined as yet; the views on the economic outlook and economic projections are quite diverging, constantly revised and vary among Member States. However, it is quite reasonable to consider that in the medium-term the crisis may, globally, have a negative impact on the banking system and lead to extensive corporate restructurings therein. It is taken as a given that the ultimate public policy objective, namely the preservation of financial stability, should not (and is not expected to) be compromised.

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[30] On the most recent projections of the International Monetary Fund (**IMF**) concerning the impact of the crisis on economic growth, see its **June 2020** *World Economic Outlook Update*, available at: https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020?utm_medium=email&utm_source=govdelivery.

[31] Available at: https://www.esrb.europa.eu/news/pr/date/2020/html/esrb.pr200514~bb1f96a327.en.html and https://www.esrb.europa.eu/news/pr/date/2020/html/esrb.pr200608~c9d71f035a.en.html, respectively.

[32] See **Gortsos, Ch. V. (2020b)**: "The application of the EU banking resolution framework amidst the pandemic crisis", in Gortsos, Ch.V. and G. Ringe (editors): *Pandemic Crisis and Financial Stability*, *op. cit.*, no. 11, p. 368.

Under this perspective, the role of supervisory and resolution authorities and the decisions they will take are of utmost importance. Taking into account the existing set of tools available[33] in order to achieve the financial stability goal and in view of the necessary flexibility that has to be (and is being) applied, the author argues that the effectiveness of policy reaction under the current conditions will be basically tested against two benchmarks:

first, how supervisory authorities will navigate credit institutions in appropriately balancing two of the primary objectives of the current policy agenda, which may, nevertheless, in the medium-term become conflicting ones: *on the one hand*, financially supporting the real sector of the economy (and hence employment) and, *on the other*, preserving financial stability; and

second, how the triggers embedded in the framework to activate the existing set of tools will be activated by both supervisory and resolution authorities.

4. The role of banking supervisory authorities

(1) National banking supervisory authorities, the EBA and the ECB are alert on the front of increasing NPLs as a consequence of the severe economic downturn, which, *inter alia*, is evidenced by the publication of two recent ECB Reports (of 26 and 27 May, respectively): "*Pandemic increases risks to financial stability*" and "*COVID-19 and non-performing loans: lessons from past crises*".[34] There are several short-term alternatives for resolving this (rapidly) emerging problem:

First, the role of credit institutions' own credit risk management assessment is a decisive factor. This applies, in particular, to the provision of new credit and loans to households and businesses during both the current and the upcoming phases of the pandemic crisis;[35] while demand for bank credit has surged and is expected to further increase, it may nevertheless (in several cases) not be fully supported by solid economic fundamentals of (prospective) borrowers. In addition, it is also more than evident that credit institutions' operational risk frameworks have also been impacted by the crisis, inducing them to accordingly revise their capital planning scenarios.

Second, it is the quality in the exercise of prudential banking supervision which will be of primary importance in addressing the NPLs problem. On this basis of the single methodology and set of harmonised tools used pursuant to the Supervisory Review and Evaluation Process (**SREP**) framework (governed by **Articles 97-101 CRD IV**), both the ECB within the SSM and national supervisory authorities (for non-participating Member States) will be in a position to assess, on a consistent basis, all four areas covered by this SREP methodology and, in particular, credit institutions' risks in capital and in liquidity. *Furthermore*, the conduct of stress testing exercises of credit institutions' portfolios, either by the supervisory authorities, including the ECB, or by the EBA, may have temporarily been suspended (at least on a generalised basis), but

[33] The probability that the framework into force cannot be excluded; this very interesting aspect is not further discussed herein.

[34] Available at: https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200526~cbbd04bd5d.en.html) and https://www.ecb.europa.eu/pub/economic-research/resbull/2020/html/ecb.rb200527~3fe177d27d.en.pdf.

[35] In this respect, of utmost relevance will be the **EBA Guidelines** of 29 May 2020 "on loan origination and monitoring" (**EBA/GL/2020/06**), which will apply from 30 June 2021 (available at: https://eba.europa.eu/regulation-and-policy/credit-risk/guidelines-on-loan-origination-and-monitoring).

are still an absolutely necessary tool in order to identify weaknesses under the current conditions.[36]

Finally, the creation of a European Asset Management Company ('bad bank'), which would be set up in order to absorb a significant stock of NPLs, has already been proposed as an alternative solution to this emerging problem;[37] relevant discussions are at an early stage and such an entity would not become operational in the short-term (provided that a decision could be reached at all given the existing divergent approaches, including with regard to moral hazard considerations).[38]

(2) For the medium-term horizon, and to the extent that problems will accumulate, three aspects deserve attention in relation to the action of supervisory authorities:

First, of critical importance will be their (prudential supervisory) approach to consolidation (mergers and acquisitions) in the banking system (relevant in this respect is the ECB draft "*Guide on consolidation in the banking sector*" of **1 July 2020**[39]), as well as the use, as appropriate, of their specific supervisory powers under Article 104 CRD IV (and Article 16 SSMR for the euro area) and their early intervention powers (in accordance with Articles 27 BRRD and 13 SRMR).

Furthermore, of particular interest is whether the conditions for granting public support to credit institutions meeting the (strict) conditions for 'precautionary recapitalisation' (as provided for in **Articles 32(4), point (d)(iii) BRRD** and **18(4) SRMR**) will be interpreted in a flexible (and hence **broader**) way in order to accommodate to the needs arising amidst the current crisis.[40] It is noted in this respect, that in accordance with **Commission Communication of 20 March** (2020/C 91 I/01) on a "Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak" (as currently in force[41]), this framework, which allows public support to be extended to companies under more flexible conditions, while ensuring the necessary level playing field in the single market, also applies to credit institutions in relation to

[36] Applicable in both cases are the common procedures and methodologies laid down in the **EBA Guidelines** of 19 July 2018 (**EBA/GL/2018/03**), adopted on the basis of **Article 107(3) CRD IV** (available at: https://eba.europa.eu/documents/10180/2282666/Revised+Guidelines+on+SREP+%28EBA-GL-2018-03%29.pdf).

[37] A similar proposal was aired in 2017 by Andrea Enria (in his capacity as Chair of the EBA) but has not been formalised.

[38] A major concern raised is the risk of higher exposure to moral hazard. On the current debate, see **Scope Ratings (2020)**: *Nationalising NPLs via European bad bank a complex and sub-optimal solution*, 27 April, available at: https://www.scoperatings.com/ScopeRatingsApi/api/downloadstudy?id=512fa81c-8c70-4640-aec1-2e19965859f1.

[39] Available at: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssmguidebankingsupervision201411.en.pdf?404fd6cb61dbde0095c8722d5aff29cd.

[40] On this form of permissible State aid under the existing banking regulatory framework, see **Gortsos, Ch.V. (2019)**: *The Single Resolution Mechanism (SRM) and the Single Resolution Fund (SRF) – Legal aspects of the second main pillar of the European Banking Union*, 5th edition (available at: https://ssrn.com/abstract=2668653), pp. 207-209 (with extensive further references).

[41] OJ C 91 I, 20.3.2020, pp. 1-9. This Communication has already been amended three times: on **3 April**, to extend the Temporary Framework to cover support for research, testing and production relevant in the fight against the crisis (OJ C 112I, 4.4.2020, pp. 1-9), on **8 May** (OJ C 164, 13.5.2020, pp. 3-15) and on **2 July** (OJ C 218, 2.7.2020, pp. 3-8).

their precautionary recapitalisation.[42] This is mainly of concern for credit institutions of "systemic relevance", namely those treated as "systemically important institutions" according to the criteria laid down in the regulatory framework and/or those whose insolvency could have a significant negative impact on the financial system due to adverse market circumstances or financial stress.

Finally, in the worst case scenario, and even though it is evidently premature to assess to what extent credit institutions will reach the point of meeting the 'failing or likely to fail' criterion[43] and, hence, resolution action will have to be undertaken in relation to them, this is an aspect which may become of significant concern from the end of this year onwards (predominantly due to the expected rise in the rate of NPLs). In this respect, it is (usually) the supervisory authorities that will be called upon to adequately assess the occurrence of this (first) resolution condition, which constitutes the clearest indication of the link between supervisory and resolution functions.

5. The role of banking resolution authorities

(1) With regard to resolution planning, the SRB has already presented its approach in view of the uncertainty and disruption caused to the economy by the pandemic crisis, setting out its remit on potential operational relief measures, its actions to support efforts to mitigate the economic impact of the crisis and its dealing with MREL targets. Resolution authorities are determined not to compromise on these targets, which they consider to be essential in terms of financial stability.[44]

(2) On the other hand, equal attention must be paid to the application, amidst the crisis, of the framework governing the resolution of credit institutions, which (with the exception of Greece in 2015) has not yet been tested under conditions of a generalised, systemic crisis. In particular, banking resolution authorities, including the SRB as the EU hub within the SRM, will also have to take delicate decisions once the first resolution condition (namely, the determination concerning the fulfilment of the failing or likely to fail criterion) is met by credit institutions[45] (on top of their power to make this determination themselves, even though this is usually made – as already noted – by supervisory authorities), paving the way for resolution action. In this respect, three main challenges arise:

The *first* relates to the application of resolution tools. In this respect, the question arises whether, under the current circumstances and on a generalised basis, the bail-in resolution tool can (or more precisely should) be considered as the appropriate instrument when resolution authorities take resolution action, due to the amplifying effect of its application for (already) distressed individuals and businesses. The author has recently defended the view that a decision to make use of this tool, at least in relation to the deposits of companies (of any size), could have severe pro-cyclical effects to the detriment of economic as well as financial stability to the extent that loans of depositors affected by the application of the bail-in tool would, very probably, become non-performing, either because these (depositors) may have been granted

[42] See **Gortsos (2020b)**, *op. cit*., pp. 379-381.

[43] See on this further **below, under 5 (2)**.

[44] On this aspect, see **Gortsos (2020b)**, *op. cit*., pp. 363-367.

[45] On this and the other two conditions for resolution under EU law, namely the criterion of the reasonable prospect for effective alternative private sector measures or supervisory action, and the 'public interest' criterion, see **Gortsos (2019)**, *op. cit.*, pp. 205-215, with extensive further references.

loans by the credit institution under resolution or due to overall liquidity problems arising from the conversion into equity or the writing down of her/his/its deposits.[46]

The *second* challenge refers to the potential activation of the so-called Government Financial Stabilisation Tools (**GFSTs**) for the provision of public support to ailing credit institutions, which (exceptionally and under strict conditions) is permissible under the regulatory framework in force. These tools are governed by **Articles 37(10)** and **56-58 BRRD** and, by design, are tailor-made for systemic crises (even though they are not available in the Member States which have opted not to make use of the relevant discretion under the BRRD).[47] Since bail-in is a prerequisite for the activation of GFSTs, in view of the (above-mentioned) negative effects of bailing-in deposits (even if only uncovered ones), it is expected that this will not be a priority option.

Finally, the *third* challenge, for the euro area, is linked to the capacity of the SRF to support the financing of resolution actions of a large scale. In this respect, it is noted that the adoption of the "common backstop" to the SRB for the SRF, which is long overdue, may prove extremely imperative in the forthcoming turbulent months and years.[48] Nevertheless, its establishment may be further delayed due to the ESM' primary focus on the **"Pandemic Crisis Support"** instrument, which was made operational by its Board of Governors on 1**5 May 2020**[49] and will absorb a significant amount of its funds.

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[46] See **Gortsos (2020b)**, *op. cit.*, pp. 370-371.

[47] For a more detailed analysis of this instrument, see **Gortsos, Ch.V. (2016)**: *A poisonous (?) mix: Bail-out of credit institutions combined with bail-in of liabilities under the BRRD – The use of 'government financial stabilization tools' (GFSTs)*, available at: https://ssrn.com/abstract=2876508, and **Huber, D. (2017)**: The Government Stabilization Tools, in World Bank Group (2017): *Understanding Bank Recovery and Resolution in the EU: A Guidebook to the BRRD*, World Bank Group, Finance & Markets, Financial Sector Advisory Center (FinSAC), April, available at: https://pubdocs.worldbank.org/en/609571482207234996/FinSAC-BRRD-Guidebook.pdf, Chapter 19, pp. 136-138.

[48] On this backstop, whose legal basis will be **Article 74 SRMR**, see **Gortsos (2019)**, *op. cit.*, pp. 256-258.

[49] See at: https://www.esm.europa.eu/content/europe-response-corona-crisis.