Threats to EU financial stability amidst the pandemic crisis

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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), the root cause of 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) 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 overall been enhanced as well.

(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'. 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 in force).

The *second* factor is the improvement in the quality of micro-prudential banking supervision, exercised 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), i.e. the first pillar of the Banking Union (designed and established as a response to the fiscal crisis in the eurozone). As illustratively noted in the 2009 Report drawn up by the *de Larosière* High-Level Group, 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), the content of which was heavily influenced by the international financial standards developed by the Financial Stability Board (FSB). 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*" stresses that these reforms made banks, globally, more resilient and resolvable, but certain gaps still need to be addressed.

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For the euro area in particular, applicable is also the Single Resolution Mechanism Regulation (SRMR), which 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) of 14 April 2020, 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.*"

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.

(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), taking into account its primary objective of price stability, the instruments at its disposal and the limitations set by the TFEU (e.g., 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 (balance-sheet) policies.

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. Equivalent initiatives were undertaken at global level by the Basel Committee on Banking Supervision in accordance with its Report of 3 April 2020 "*Measures to reflect the impact of COVID-19*".

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 to credit institutions (on the basis of the "comply or explain principle") to temporarily ban the payment of dividends by credit institutions. In addition, the ECB fully supported, in its Opinion of 20 May, the upcoming Regulation amending the CRR "as regards adjustments in response to the COVID-19 pandemic".

Finally, noteworthy is also the contribution of the European Systemic Risk Board (ESRB), 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.

(3) It is also noted that, with a view of 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 targeted interventions in relation to credit institutions' resolution planning. In addition, in relation to financial stability in capital markets, the European Securities and Markets Authority (ESMA) has also taken a series of specific measures, 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 (as in force, MiFID II).

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 during the coming months (even though accurate assessments cannot obviously be made as yet). 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 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.

(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). Financial Stability Reports (final and interim) published during the last weeks highlight this aspect.

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).

(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. 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 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*, supporting financially 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.

On 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*". The short-term alternatives for resolving this (rapidly) emerging problem are several:

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; 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 are still an absolutely necessary tool in order to identify weaknesses under the current exceptional conditions. Applicable in both cases are the common procedures and methodologies laid down in the EBA Guidelines of 19 July 2018.

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; a similar proposal was aired in 2017 by Andrea Enria (in his capacity as Chair of the EBA), but has not been formalised. In any case, 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).

(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), as well as the use, as appropriate, of their specific supervisory powers under Article 104 CRD IV (and Article 16 SRMR 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. It is noted in this respect, that in accordance with Commission Communication of 20 March on a "Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak" (as in force), 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 their precautionary recapitalisation. 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 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 will be called upon to adequately assess the occurrence of this (first) resolution condition, which constitutes the clearest indication of the link between the supervisory and resolution functions.

On 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 as essential in terms of financial stability.

(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 (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 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.

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). Since bail-in is a prerequisite for the activation of GFSTs, in view of the (just 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. Nevertheless, its establishment may be further delayed due to the ESM' primary focus on the operationalisation of the "Pandemic Crisis Support" instrument, which will absorb a significant amount of its funds.