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European bank regulators are not yet doing what it takes

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Ignazio Angeloni: The return to normality after the coronavirus pandemic requires, among other things, that banks be saved, and this will not happen unless regulation is adapted and more public support is provided

This text by Ignazio Angeloni was published first on 24 March by VoxEU (https://voxeu.org/article/european-bank-regulators-aren-t-yet-doing-what-it-takes).

One after another, all the long-held tenets and taboos of Europe's postwar rule-based liberal order seem to be falling away. National borders close. Personal liberties are curtailed. Governments rule by decree, while deserted parliaments hastily rubber stamp. Fiscal limits are overstepped; barely noticed, days ago, were the suspension of the EU stability pact and the approval of a jumbo budget deficit plan by Germany (https://www.ft.com/content/dacd2ac6-6b5f-11ea-89df-41bea055720b). The European Central Bank (ECB) has launched a massive monetary attack (https://www.ft.com/content/711c5df2-695e-11ea-800d-da70cff6e4d3) using all its instruments, and made no secret of its readiness to trespass its hitherto ‘red lines’ in terms of which and how many assets it can buy.

This is exactly what should happen. Against a fearsome and unknown enemy, the sensible strategy is to overwhelm by speed and size. This applies to the health and the economic areas alike. “Whatever it takes” in present circumstances means “More than you consider sufficient”. Acting quickly and big (https://www.ft.com/content/bc1cd972-6a8e-11ea-a3c9-1fe6fedcca75) is of the essence.

A war-like approach for banking regulation

The only exception to the prevailing war-like approach at the moment is banking regulation. This is surprising: it should be well understood that banks are the key to providing financial oxygen to the economy. Even the ECB’s big bazooka cannot work fully if banks cease to function or, heaven forbid, go bankrupt on a massive scale. Yet this is precisely the risk the euro area faces, if a real economy in freefall – at it will surely be at least for several months – results in a surge of credit defaults and massive losses on market exposures.The latter have already occurred; the former is a virtual certainty.

Regulators – the EU, national governments, law-makers and supervisors – must act decisively and urgently to block this doom scenario. Following a logic applied in other areas – from labor markets (https://www.ft.com/content/927794b2-6b70-11ea-89df-41bea055720b) to corporate subsidies (https://www.bloomberg.com/news/articles/2020-03-23/germany-approves-800-billion-package-to-counter-virus-impact)– the goal should be to ensure that banks overcome the critical phase as unharmed as possible. For that purpose, normal prudential rules should not apply to the effects of the virus on their balance sheets. Such effects should instead be neutralized by public support – capital injections, guarantees, and for what is left, supervisory forbearance. The attack needs conducting on three fronts: bank assets, bank liabilities, and bank governance.

Measures of the European Central Bank

On the asset side, ECB supervisors (https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200320~4cdbbcf466.en.html) have promised “to allow banks to fully benefit from guarantees and moratoriums put in place by public authorities”. This commendable intention , however, leaves the ball in the hand of national authorities, not all of which are willing or able to play their part. The Italian budget package approved last week, dubbed “cura Italia” (“cure Italy”), contains no mention of such guarantees; it concentrates – understandably given local conditions – on supporting families and the health and other priority sector. On the contrary, the German plan earmarks €400 billion for corporate loan guarantees. As currently set, the combination of conditional forbearance by the ECB and wide differences across borders risks increasing bank fragmentation and penalize ‘southern front’ countries which are hit hardest by the virus.

Protecting the liability side requires propping up both funding and capital. The actions undertaken by the ECB through its long-term (LTRO) and conditional (TLTRO) open market operations aim at keeping funding sources open. Their effect, however, depend on banks having enough ‘adequate’ collateral – a requirement set in the Treaty. The availability of such collateral is likely to be highly asymmetric, exacerbating the aforementioned fragmentation. Capital is also likely to become a constraint. ECB supervisors have pledged leniency

(https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200312~43351ac3ac.en.html)in administering their Pillar 2 Guidance, but P2G is only a small fraction of the overall capital requirement (https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200128~20e2703d8e.en.html).

European law contains no escape clauses to reduce capital obligations in emergencies or downturn. The only flexibility lies in the so-called macroprudential buffers, which unfortunately were raised little during the preceding cyclical upturn. At the present juncture, the much-needed capital flexibility can only come either from a suspension or deferment of existing legal capital requirements, or from injections of capital by the public sector, banned under EU state aid rules. Commissioner Margrethe Vestager published on 17 March a “temporary framework (https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT_20_479)” containing a number of virus-related relief measures, but not this possibility.

Suspension of prudential norms, asset guarantees, public ownership – all needed under present circumstances – would bring the euro area’s banking framework close to wartime conditions for a limited but indefinite period. Restrictions in certain bank managerial decisions would be inevitable, first and foremost in the distribution of bonuses and dividends (https://www.ft.com/content/ed87b5d6-6a8e-11ea-a6ac-9122541af204), as recommended by the Systemic Risk Council (https://www.systemicriskcouncil.org/). Interference in other areas on a temporary basis may also ensue. While free market diehards may turn up their nose, this is probably a lesser evil. The return to normality we all crave requires, among other things, that banks be saved. They will not unless regulation is adapted and more public support is provided.

Ignazio Angeloni (https://safe-frankfurt.de/policy-center/safe-senior-policy-fellows/senior-policy-fellows-ignazio-angeloni.html) is a Senior Policy Fellow at the Leibniz Institute for Financial Research SAFE, a Senior Fellow at Harvard Kennedey School, and a former member of the ECB supervisory board.

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Leibniz Institute for Financial Research SAFE

Theodor-W.-Adorno-Platz 3
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Phone: +49 69 798 30080
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