Conference Report

on the

2nd EBI Policy Conference 2020

'Europe and the Covid-19 Crisis – Looking back and looking forward'

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A. Introduction

As it's two central elements, EBI's work includes academic work on the one hand and policy work on the other. The academic work centers around the EBI Working Paper Series, the EBI Discussion Paper Series, academic conferences all over Europe and the central academic conference, the so called Global Annual Conference (GAC), which takes place in Frankfurt/Germany annually. The policy work of EBI was more recently launched. It started in 2019 with the 1st EBI Policy Conference. Since then, EBI has developed a monthly Policy Speaker Series with the EBI Policy Conference being the key Policy Conference of EBI, which always takes place in Frankfurt/Germany in November each year. In this context, the 2nd EBI Policy Conference took place on the 4th/5th November 2020. Due to the Covid-19 crisis, the EBI Policy Conference took place virtually, as was the case with GAC.

Both the EBI Policy Series and Policy Conference aim to bring together top policy makers from all across Europe with practitioners from the public and private sector as well as academics from EBI and beyond. In this form, EBI wants to contribute to current policy related discussions.

Due to the Covid-19 crisis, supervisors, regulators, central banks and the legislators across Europe have taken action in many different forms in order to react to this crisis. In many cases, EU action was in completely new territory. The EU recovery fund is just one example in this regard. Therefore, public action has given a great starting point for policy discussion. At the same time, it is not clear how this crisis will develop and what further action(s) may be needed. Therefore, it was also a key target at this year's conference to discuss possible additional action needed by the public sector. Due to the strong participation of all key European bodies, the EC, the ECB, the SSM, the SRB, the EBA and the European Parliament, this year's conference was a great success for EBI. Many key topics in the current policy debate were addressed in the key-note speeches and then discussed in subsequent discussion rounds and Q&A sessions. Needless to say, the set-up in the form of a virtual conference was not as "grasping" as a physical conference would have been, where the enthusiastic participants are more easily managed. However, the conference can be considered a great success of EBI as excellent feedback from all participants was received.

The following is a summary of the Global Annual Conference.

B. First Day – 4th November 2020

The first day of this year's policy conference was opened with a few introductory remarks by the President of the Supervisory Board, Dr. *Thomas Gstädtner*. He then continued addressing specific effects of this crisis on banking and capital markets, outlining that this pandemic is uncharted territory and appears as a monstrous mash-up of the great depression, the global financial crisis of 2008 and 2009 and the aftermath of the 9/11 events, in particular regarding the size, speed and fear caused. This is reflected in the IMF's estimation of the global economy shrinking by 4.4 % in 2020. With a decline of 8.3 %, the impact appeared to be even greater in the Eurozone. Dr. *Gstädtner* says that this recession is also affecting the labour market, as the level of unemployment hit industrialised nations very hard and very fast; e.g., in the US within early weeks of the crisis, the number of jobless benefit claims reached more than 30 million, while in Germany the number of short-term work applications (*Kurzarbeit*) also went up on a massive scale.

Yet on the other hand, there was also positive news to share: Supervisory Authorities, Central Banks and other Authorities responded swiftly to the crisis. In particular, the ECB implemented various measures to fight the pandemic and conducted remarkable monetary policies, e.g., the 750 billion Pandemic Emergency Purchase Program (PEPP). All of this was done in order to enable banks to provide liquidity to the real economy. On the supervisory side, Dr. *Gstädtner* mentioned that the ECB allowed banks to exploit the full regulatory flexibility in the use of capital and liquidity buffers under stressed conditions. Additionally, bigger flexibility was granted regarding the "unlikely-to-pay"-classification for borrowers who are recipients of *ad hoc* government guarantees or for whom moratoria have been enacted. It was noted that banks as lenders have a vital role to play in this pandemic. From a regulatory point of view, it can be noted that the European Banking Authority (EBA) and the European Commission (EC) encouraged all supervisory authorities to use supervisory flexibility in capital and liquidity requirements. Nevertheless, the nexus between banks and their sovereign is still alive, which, in Dr. *Gstädtner*'s view, is usually seen as negative by markets, if and when either the banks or the states – and in the worst case both – are perceived as particularly weak.

It was then emphasised that it is important that the pandemic crisis does not turn into a systemic state crisis. To avoid this, the creation of a full Banking Union (BU) and a Capital Markets Union (CMU) is an important priority. He concluded his opening speech by stating that he is very pleased to welcome all the participants, even though it was not possible to organise this conference in person due to the pandemic. He also thanked the *Stiftungsprojekt Kapitalmarktunion* for their kind support of this event.

I. Session 1: Europe's response to the Covid-19-crisis by Mr. *Valdis Dombrovskis*

The first keynote speech and therefore the opening of this 2nd Policy conference was held by Executive Vice President of the EC Mr. *Valdis Dombrovskis*. Right at the beginning he outlined, that the second wave of the pandemic has hit Europe and that it is not over yet, rather the hardship will continue, affecting not only the economy but all sectors of society. According to *Mr. Dombrovskis*, it is important to keep people healthy, but also keep them in work. The Covid-19 pandemic caused a major recession, which is why recovery will be slower than expected. This is shown by the fact that the pace of recovery is slowing down in winter.

Nevertheless, the EU and also governments, central banks and other institutions have acted decisively with policies. Measures such as making € 88 billion available to finance short-term work schemes helped to minimise the impact of the pandemic. He also mentioned that recently the EC had its first bond issuance, which attracted strong interest by institutional investors.

Mr. Dombrovskis stressed that Europe also needs to think about its future beyond the pandemic and address challenges such as climate change and digitalisation - both of which are areas of opportunity. However, in terms of jobs, no one should be left behind. It is crucial to create long-term European prosperity and with respect to this, a green and digital transformation must take place.

In terms of the financial sector, the aim is to have deeply integrated capital markets, strong public finances and a strong banking sector. In the current crisis, it is clear that banks are better capitalised and more stable than in the last crisis. Moreover, in this crisis banks have played a positive role in lending to the real economy. The EC has already taken easing measures and should not hesitate to act also in this second wave of the crisis. A financial crash must be avoided, as it would deepen the crisis. In *Mr. Dombrovskis*' opinion, capital buffers should be used by banks.

He then addressed the BU, saying that the pandemic hit the EU economies at a time when the flagship project was still unfinished, although it has already highlighted the benefits of the BU and safety nets. The well-functioning of the BU will allow banks to fully participate in the recovery and mitigate the effects of the crisis. But so far, the third pillar of the BU is missing, the European Deposit Insurance Scheme (EDIS). Additionally, the EU crisis management framework should be strengthened, and the CMU must be completed. Especially the latter, he said, is essential to accelerate recovery, achieve sustainable growth and enable investments in new assets and infrastructure. *Mr. Dombrovskis* noted that both will bring the EU closer to a vibrant and stable monetary union.

In summary, the crisis illuminates the EU's unfinished projects. The EU has a strong international role to play. Even though the pandemic is an unprecedented crisis, solidarity will lead the EU out of it.

After *Mr. Dombrovskis*' speech, Dr. *Gstädtner*, as the moderator, addressed several questions. Firstly, Dr. *Gstädtner* said, one crucial point in relation to the Recovery Fund was the question how it can be ensured that the monies are used according to a European principle and under the control of European authorities, and secondly, how can it be ensured that the grants are coming in conjunction with economic reforms in each country. He also wanted to know which solution was found in this regard and how it will be ensured that reforms will be implemented and not just announced.

Mr. Dombrovskis replied that there has been considerable initial funding and that it is now important that the monies are used effectively. Each Member State (MS) must prepare a recovery and resilience plan consisting out of a comprehensive set of reforms and investments. According to *Mr. Dombrovskis*, a great priority is green and digital transformation. To secure these requirements, funds will be disbursed in tranches after fulfilling certain benchmarks, e.g., reforms, advancing investment projects. Consequently, additional financing is only possible if these requirements are met.

Secondly, Dr. *Gstädtner* said that the "Recovery Fund" has been a truly controversial matter between the MS. He asked, if we are getting closer to a fiscal union that accompanies the current monetary union.

Further, how will the EC ensure that states who don't like this approach are not getting more eurosceptic? And finally, if the EU really needs a fiscal union or if it could not work on the basis of coordinated but decentral fiscal policies under the auspices of the Stability and Growth Pact.

Mr. Dombrovskis replied that the Recovery Fund is primarily a crisis response. It has taken a long time to agree on a common response as it is never easy to agree on a stimulus package of such scale. When it comes to the Next Generation EU funds, it is explicitly a temporary crisis instrument. It will be available until 2024 and paid out until 2026. This is somewhat of a test case and if it is successful and helps with recovery as much as stabilisation, further discussions could arise.

Thirdly, Dr. *Gstädtner* mentioned academic research on monetary union which is dealing with the need for shock absorbers in a currency union. Integrated capital and credit markets are seen to be good and actually better shock absorbers than transfers of public funds. This leads to the need for a more integrated BU with further risk reduction and with delinking sovereigns and banks on the one side and risk sharing on the other side. He stated that there is hardly a single state which likes the full concept. Some don't like the idea of risk sharing other states dislike the concept of risk reduction when it comes to sovereign bonds. Therefore, he raised the question of how *Mr. Dombrovskis* would approach this and what his solution is in this regard. Further Mr. Gstädtner asked, what approach the EC follows to get a real single rule book for the BU.

Mr. Dombrovskis admitted that when discussing public shock absorbers through these measures it is also important to look at private shock absorption. Therefore, the work on the BU and CMU come into play. The broader policy dilemmas, e.g., BU, EDIS, they are facing and discussing about no solution has been reached so far. But in fact, there is a strong push needed to complete the BU not only but also for dealing with illiquidity in resolution. Additionally, the broad policy dilemma must be solved which is essentially addressed with the question of risk sharing vs. risk reduction. From the EC point of view, it looks at the fundaments of the BU and will review this topic by the end of 2021. In doing that the EC will assess also the CRR, CRD within the discussed review.

Fourthly, Dr. *Gstädtner* highlighted the aspect of CMU and asked, if Europe is dependent on the London capital market and what needs to be done in order to create a proper European market. He added, whether the EU needs something like the SSM for capital markets instead of 27 different authorities. How can Europe restore growth via the CMU?

Mr. Dombrovskis conceded that it is true that the largest financial centre will leave the EU and also the single market and that this will have an impact on how capital markets will function across the EU. He said that the EU will become a more multipolar capital market landscape but also underlines that the CMU predates Brexit and that its fundamental aim did not change. The crisis brought new dimensions to capital markets. Now it is the time to strengthen the infrastructure through a capital market growth package. *Mr. Dombrovskis* pinpointed that there needs to be a broader scope for supervision at EU level and also the question on how ESMA can be strengthened needs to be raised.

Lastly, Dr. *Gstädtner* addressed that in June 2020, the Parliament approved a temporary relaxation of prudential rules for European banks, commonly known as a "quick fix" to the Capital Requirement Regulation (CRR). Taking into consideration the magnitude of the second wave in the Covid-19 pandemic, he asked if the EC is currently aligning with the European Parliament in order to extend the measures or to create new ones to mitigate the economic consequences of a second European COVID-19 lock-down.

Mr. Dombrovskis answered that the EC is assessing the situation and evaluated the necessary steps. A new action plan regarding non-performing loans (NPLs) is being prepared. There are new steps necessary, but the EC is not aiming for a wholesale of regulation or for a reduction of capital requirements. Now, well-capitalised banks with capital buffers are important along with an answer to the question of how capital buffers can be used more easily in crisis situations.

II. Session 2: The Monetary Policy response of the ECB to the Covid-19-crisis by Prof. Dr. *Isabel Schnabel*

The second session was moderated and opened up by Prof. Dr. Prof. Dr. *Christos Hadjiemmanuil* and Prof. Dr. *Luis Morais*. The keynote speech itself was held by Prof. Dr. *Isabel Schnabel*, member of the Executive Board of the ECB.

In her speech Prof. *Schnabel* looked partly back and partly forward. Right at the beginning, she noted that new containment measures are needed as the pandemic will slow down the recovery, which will require new fiscal measures. She also pinpointed how the situation in November differed from the one the EU was facing in spring and which challenges monetary policy has to confront in the current environment.

She cited that the first measures were taken in spring when financial conditions were tightening significantly because the crisis hit. This can be seen in the fact that in the Eurozone the stock market crashed by 35% within a few weeks. Also, the sovereign bonds market fragmented. The stability of the financial system was at risk and the transmission of monetary policy was impaired. Prof. *Schnabel* used profound and deep tools to highlight the economic impact of the crisis on the Eurozone. For example, using the so-called CISS indicator, she showed that the global financial markets were affected in a similar way as in 2008/2009. She noted that the economic and health crisis should not develop into a full-blown financial crisis.

The ECB's response to the pandemic consists of two reinforcing and complementary pillars. One is the Pandemic Emergency Purchase Program (PEPP), which contained a sum of 750 billion Euro in March and was raised to 1,35 trillion Euro in June, representing a total of 11% of the Eurozone's GDP. According to Prof. *Schnabel*, this mechanism should last at least until June 2021 and beyond, as long as the crisis persists. It is intended firstly to counter risks to the monetary policy transmission channel by stabilising the financial markets and secondly to cushion negative shocks to the economy.

The ECB itself is acting as a lender of last resort and safeguarding the lending channel in crisis, guaranteeing lending to the real economy. Due to the large take up of funds in summer, when banks contrarily to previous crises this time acted as a backstop to the economy benefitting from high capital buffers. Following Prof. *Schnabel* now a much broader set of assets with a much more favourable approach is applied. Without swift action the standard would be much worse than it is now. The measures taken have complemented and reinforced the strong fiscal expansion in the euro area paving the way for a recovery in economic activity in the third quarter of 2020.

Prof. *Schnabel* also addressed the use of calibrated instruments to respond to the unfolding situation to ensure financing conditions and to counteract the projected inflation path. Of course, an assessment will follow by taking a vaccine into account. Furthermore, she the recognized, that new partial lockdowns have a much more localized impact and that the market functioning remains smooth, without fragmentation. Even better today the EU GDP is already well below pre-pandemic level.

Nevertheless, Prof. *Schnabel* reminded the audience that in the current situation it would be naïve to take the stability of the Euro bond market for granted. Monetary policy, she said, faces far greater challenges, such as the transmission from monetary policy to the real economy in a low interest rate environment with changing framework conditions. In addition to various graphs and data to illustrate the complex ground of the current economic situation, it is eminently important for fiscal policy in times of low interest rates and high uncertainty to pull the economy out of the trap of high inflation and low growth. The measures must have a strong and immediate effect.

Prof. *Schnabel* concluded by saying that, given the second path, further monetary policy measures are needed to ensure favourable financial conditions and economic activity. In the coming weeks, the Governing Council will examine how the toolkit should be adjusted to best support the economy based on the medium-term inflation outlook. In doing so, the regulatory measures will remain proportionate.

Subsequently, Prof. *Morais* asked Prof. *Schnabel* to further elaborate on the general macroeconomic outlook, particularly on how she envisages the resurgence of the pandemic and related public health measures. He also asked for an outlook with regard to the extension of the range of the possible outcomes in economic projections or alternative projection scenarios.

Prof. *Schnabel* answered that there has been seen a strong rebound, but also that it is now slowing down in the fourth quarter. From a macroeconomic point of view, this pandemic crisis is characterized by the fact that one can see a dichotomy of effects with regard to the services sector and manufactures sector. In particular, said Prof. *Schnabel*, the contact-intensive sector is strongly affected, and the manufacturing sector is benefiting from the rebound in China. Nevertheless, the uncertainty remains high, and it depends very much on the vaccine. This also applies with regard to sustainable fiscal support. In general, there are different scenarios due to the large variations.

Prof. *Morais* then addressed the monetary policy strategy review of the ECB and asked Prof. *Schnabel* to comment on the ECB medium-term orientation and how flexible it is going to be. Prof. *Schnabel* replied that the ECB has just resumed its work in this regard. She noted that this is very extensive, addressing a variety of issues and also includes the medium-term orientation, which is a crucial and very well-serving component. Prof. *Schnabel* said it allows one to see through short-term temporary developments and helps to deal with lags in monetary policy transmission. Finally, flexibility is very desirable and necessary.

Prof. *Hadjiemmanuil* then asked whether the TLTRO also works in the same way as the PPP-program. Noting that this is an important question, Prof. *Schnabel* said that generally the ECB is considering proportionality, effectiveness and side effects, which is also true for these particular instruments. The TLTROs are the main instrument for the bank lending channel in the bank-based EU. She added that there has been a huge amount of lending in spring, without which the economy would be in deep trouble. It is then hard to argue that this is not a result of the ECB's liquidity measures. But besides that, according to Prof. *Schnabel*, the ECB has also looked at microeconomic data, and what you can see so far is that lending has been higher among banks that have had a higher take-up of TLTROs, which is an indication that things are going in the right direction.

Prof. *Hadjiemmanuil* then asked, what happens if banks are faced with a sharp increase in borrower defaults and simultaneously being stuck with low interest rates given that the return to old normality is precluded by monetary conditions. Are there any alternatives? Prof. *Schnabel* replied that negative interest rates have been considered controversial. But when considering the overall measures, it is important that the measures stimulate the economy, which makes loan defaults less likely. This is a crucial channel to consider. The ECB will consider all types of measures and has so far concluded that other instruments are more appropriate, which is why a rate hike is not on the table.

III. Session 3: The Supervisory Approach of the SSM to the pandemic crisis by Mrs. *Alessandra Perrazzelli*

The third and last session of the first day was moderated by Prof. Dr. *Eddy Wymeersch* and Prof. Dr. *Marco Lamandini*. After a short introduction of *Alessandra Perrazelli*, Bank of Italy and Member of the ECB Supervisory Board, she started her keynote speech.

In her presentation, Ms. *Perrazelli* presented a supervisory perspective that she believes is important to promote a comprehensive and coordinated approach, which is essential in this crisis. Right at the beginning, she stressed that all types of supervisors are faced with difficult trade-offs. This crisis is characterised by an unprecedented level of unpredictability, although the European banking sector is in better shape than in the past. Unlike in 2008, banks are not the cause of the crisis but can furthermore play an important role in resolving it.

Mrs. *Perrazelli* said that the new challenges generated by this pandemic are compounded by structural problems and the witnesses of the financial system. Digital transformation is erupting in the banking and financial sector and the pandemic is accelerating remote services. At the same time, she identified disincentives for cross-border mergers. In terms of long-term strategic issues, it is necessary to consider how the sector will evolve in the coming decade. In addition, digitalization has created new markets and new players can enter and can jeopardise established players, which raises challenges for banks and supervisors.

Mrs. *Perrazelli* then went on to discuss the two principles on SSM level: At first, the SSM intends to provide supervisory relief to help banks to support the economy. This is reflected by the fact that they should use capital buffers to support clients. This allows banks to focus their resources on the effects of the current crisis. Second, the SSM attempts to ensure the resilience of the banking system by asking banks not to distribute dividends in order to keep as much capital as possible in the sector.

The banking system as a whole should be able to absorb credit losses. The SSM has emphasised in the last years the reduction of NPLs. Many banks achieved this target, and this helped to increase the resilience of banks. Mrs. *Perrazelli* noted that if our banking system had entered this crisis with lower capitalization levels and without a significant reduction of impaired assets, the consequences of the pandemic would have been much more difficult to manage.

The SSM has agreed with the EBA to postpone the stress test planned for 2020 to 2021, but the preparation face for the EBA/ECB stress test is ongoing. The current strong resurgence of the pandemic will make this very difficult to carry out also because of the banks' logistics are being impacted by the current measures. The results will have to be analysed very closely.

Furthermore, with regard to the pillar 2 requirements banks must be able to finance households and corporations even in the event of financial difficulties. For this reason, the ECB has allowed banks to temporarily operate below the capital requirements defined in pillar 2. Banks are allowed to partially use capital instruments that do not qualify as CET1 capital to fulfil their P2R requirements, i.e., AT1 and T2 instruments.

The SSM restrictions that no dividends are paid until January 2021 aims to ensure that no capital flows out of the banking sector. According to Mrs. *Perrazelli*, there are strong arguments to support this approach, such as the resilience of the financial sector, the capacity to lend to the real economy or a better ability to absorb losses. On the other hand, it may undermine the relationship between banks and investors and may negatively affect the availability and cost of market funding. She sums up that this price was worth paying at this point of time, but the big question now is whether or not the conditions which have led to the dividend's restrictions have changed significantly.

Another supervisory measure deals with IFRS 9. The SSM provided guidance to mitigate volatility in banks' regulatory capital and financial statements stemming from IFRS 9 accounting practices and to avoid excessively procyclical assumptions. The SSM encouraged banks to implement full IFRS transitional arrangements.

In summary, the current challenges are unprecedented, Mrs. *Perrazelli* said. There is no clarity yet on the magnitude of economic consequences and there are possible cliff effects. They come alongside other new risks arising from a technological push, climate change and Brexit. Of course, these aspects can be regarded also as opportunities to the extent that they are dealt with proactively by the banks. The supervisors are working for the new normal and the next challenge is to implement a third pillar to finalize the BU. This also applies with regard to a crisis management framework. In Mrs. *Perrazelli*'s view, all this depicts a complex picture with very different national measures. She appeals that everyone must work together to achieve a European response.

After her speech, Prof. *Lamandini* addressed the first question and wanted to know how the capital conservation buffer relief worked in practice. Mrs. *Perrazelli* answered that the release of the buffer was perfect in keeping the spirit of the post crisis reform. There are still limited possibilities and market factors, macroprudential and supervisory factors may undermine the willingness of banks to accept a decline in capital ratio. At the same time the mismatch between temporary forms of capital relief and the different time horizon of lending activities may also impact on the banks actions. Also, it should be aimed that capital relief is fully aimed to support the real economy and not be used by banks to pay discretionary distributions.

Prof. *Lamandini* then led the focus on the Pillar 2 guidance and asked what the path to normality will now look like. How can we translate flexibility into the Pillar 2 context? Is the stress test in 2021 really necessary?

Mrs. *Perrazelli* replied that the path to normality will depend on a number of factors which will be monitored carefully. The stress test will provide important insights. Banks will be tested on the basis of the pandemic scenario. If the situation has stabilized the stress test results can be used to identify an exit strategy. But even if economic conditions do not improve, Mrs. *Perrazelli* added, the stress test should be used as an input to the macro perspective. In any event flexibility should be guarded with regard to the results of this exercise.

Prof. *Wymeersch* also had some comments to share. He stressed that the advantage of a crisis is to think about the future and that, in his opinion, preparations for the period after 2021 seem to be quite weak. NPLs will increase significantly – he asked: "*Are we armed for it*?" Further he wanted to know, what will happen to pensions funds with regard to limited dividends distribution, if they want to honour their pension obligations.

Mrs. *Perrazelli* answered that regarding NPLs banks have done a lot in the past to deal with them. In terms of strategy, governance and risk management is important and there are a number of different measures of both quantitative and qualitative nature. She added that there is no doubt that banks have to continue to manage them. On a forward-looking perspective, some banks have improved their provisioning beyond 2021 as they face the second wave. Looking ahead, it is crucial that regulators and supervisors find a balance between avoiding procyclical credit restrictions and maintaining forward looking risk management practices. Generally, proactivity is crucial for the time after 2021. Regarding the ban on dividend distribution and share buybacks, the SSM guideline is under revision. The SSM hears the market and the need for clarity.

Last but not least Prof. *Wymeersch* raised the point on what happens if small banks default and if there occur insolvencies. According to Mrs. *Perrazelli*, this is the time to work on a system for small banks as they are an extremely important as part of the economy. She called them "locally" significant banks. Lastly, the bank of Italy launched a call for paper addressing this issue.

The first conference day then was concluded with some closing remarks by Prof. Dr. *Christos Gortsos*. He summarized that it was an extremely interesting session with panellists of very high quality and with important messages.

C. Second Day – 5th November 2020

Just one day later, the second day started with some general remarks by Dr. *Gstädtner*. He began with a brief summary of the first day and then handed over to Dr. *Philipp Nimmermann*, State Secretary of the Ministry of Economics in Hessen.

Dr. Nimmermann stated that it is very important to have these kinds of events, as the pandemic has brutally shown the weaknesses of our society. Nevertheless, the state of Hessen has overcome some hurdles for banks. Generally, the economy has stabilized but next year the bigger challenge awaits. The question will be, says *Dr. Nimmermann*, how the banks and companies will come out of the crisis or whether there will be zombie companies.

In his eyes, the most important lesson from the crisis is to see the similarities between the pandemic and climate change. He said that it is important to stress test banks for these events and this is already a stress test for pandemics. But regarding the future, other natural disasters should be considered. He asked: "*What can be done*?" The answer lies in the financial sector getting used to these tests and helping the real economy understand this complex work. There must be a forward bouncing resilience and (hopefully) future crisis can be taken easier.

I. Session 4: Banking Resolution in times of Covid-19 – Lessons learned from the crisis by Dr. *Elke König*

The first keynote speech then was moderated by Prof. *Gortsos* and Prof. Dr. *Georg Ringe*. After a few introductory words of Prof. *Ringe*, Dr. *Elke König*, Chair of the Single Resolution Board, started with her speech.

Right at the beginning she noted that the SRB not only reacted to the crisis but also went beyond. There is both a social aspect and an economic one to this situation and she compared trying to get control of it to "*steering through the fog*". "*So how can one ensure that financial stability is promoted, and the taxpayer is not on the hook*?" When answering to this question, she firstly wanted to focus on the current regulatory environment, secondly to highlight the measures that authorities such as the SRB have taken and thirdly to look forward to what is expected from the banks and how the unwinding of the measures should take effect.

Dr. *König* stated that at EU level, one should feel proud of what has been put in place. The measures from last crisis have taken effect and prevented worse. The BU is a milestone with the SSM and SRB firmly in place. The SRB is fully operational and has built-up experience and expertise over its five years of existence. Next to other achievements, e.g., the Single Resolution Fund, there is still work to be done.

With respect to the emergency measures since the start of the pandemic, governments and regulators reacted swiftly. The financial authorities took a coordinated approach with the ECB and the EBA and the SRB have been closely working together. More specifically, the SRB tried to focus on the application of operational relief matters for the banks under its remit. The flexibility of the framework has been in use and pragmatic measures have been applied. Nevertheless, resolvability was never compromised. Next to that, Dr. *König* noted, that less urgent requests for information were postponed. Additionally, she pointed to the capital relief measures to support the real economy by the ECB. They have been carefully monitoring market conditions, looking at banks' balance sheets or the transition period for MREL. In summary, she noted that the situation of banks today is better than many initially feared. Governments are providing support for the real economy and banks have played their role in keeping the economy turning and have been shielded by governments' support for the real economy.

Looking ahead and considering what issues are emerging, Dr. *König* quoted: "*To fail to plan is to plan to fail*." Then, in the context of the SRB, she phrases, "*To fail to prepare is to prepare to fail*." In fact, however, they are confident of being prepared. It is the time to move forward and to ensure that important elements such as the MREL are strengthened.

Further, the cost of funding has decreased recently and there can be seen an operational readiness in resolution and resolvability. Banks therefore must keep up the momentum on increasing MREL. In terms of transparency Dr. *König* noted that there is the expectation for bank documents to be published in spring. The expectations for banks documents remain the clear and transparent guide for banks to work on making themselves resolvable. In general, the better the financial sector plays this role, the less it will be required to look at impediment procedures.

Moreover, she expected to see more NPLs on banks' balance sheets in the future and banks should have a clear focus on this topic. The sooner the better, she conceded. Banks must sell out the viable from the non-viable loans. Generally speaking, adequate and early provisioning has never hurt. Further, Dr. *König* added that asset management companies (AMSs)/bad banks can be a very valid tool, but it is certainly not a magic wand to make losses disappear. There are only a few asset classes really benefitting from being managed through AMCs. That said, it is probably clear that companies with weak business models or weak performance prior to the arrival of the pandemic are unlikely to have become stronger in the interim. It is very important to support companies including banks only if they have a sustainable business model after the pandemic, which is easy to say but difficult to implement in Dr. *König*'s eyes.

According to Dr. *König*, there is some good news because the SRMR framework is functioning. However, she hopes that it will not have to be used too often. The support measures for banks must be adopted carefully, because a resolution framework should not be unwound.

Finally, when looking forward, a common European system for deposit insurance is not yet around the corner. It will take a longer time, following Dr. *König*. Further, the work on the third pillar must be completed and the backstop for the resolution fund must be put in place. From a broader view the CMU needs to make progress there. In addition, a harmonized insolvency or liquidation regime is needed which she further elaborated on. Especially mainly deposit-funded medium sized banks are currently sometimes considered to be too big to be resolved under national insolvency law but at the same time too small for resolution. She wonders whether this is the right focus or rather to focus on how to resolve. The SRB has been clear that the harmonisation of insolvency regimes for banks is a necessary end-goal which unlikely will be achieved in the short term.

In summary, the resolution framework is far from perfect, but it works. It allows banks to withstand shocks, which is also why banks are part of the solution this time and not the cause of the crisis.

The discussion part was opened by Prof. *Gortsos* by asking the first question whether major obstacles to the establishment were identified during the preparation of SRMR 2 and BRD 2. Also, he wanted to know why the common backstop is not yet fully established. In his eyes, this should be a topic for the very short-term agenda.

Dr. *König* replied that the common backstop is part of the ESM Treaty amendments. It is basically held hostage in the political debate. She pinpointed that between the ESM and SRB the paperwork has been finalised already in 2019. There is more or less a belief and a philosophical debate about whether there has been sufficient risk reduction to enter into risk sharing. What has been seen is that 2020 is a year of transition. The real challenge and problem are to wait for policy statements for some top issues.

Afterwards, Prof. *Ringe* wanted to know what role technology plays in the resolution context, more precisely supervisory technology, also with regard to resolution areas. Dr. *König* answered, that the technology is advancing fast. Nine months ago, one would not have believed it possible to work remotely on a complete resolution circle, whereas today the SRB is even able to resolve a bank remotely. She stated, that in challenges chances lie alike. But she also noted that one cannot only rely on technology.

Prof. *Ringe* inquired further on this point and raised the question whether Dr. *König* could imagine that one day resolution plans will be submitted online and reviewed by an algorithm or whether there would even be automatic decisions. Dr. *König* could imagine getting additional insights with AI, which is not possible yet. She believes that one can get more of it, but in the end supervision and resolution is judgmental and there exists something like a good feeling if something is a good business model and if there is an opportunity. It is questionable whether that is replaceable.

Prof. *Gortsos* then asked Dr. *König* for a brief cost-benefit analysis of having a bad bank. Additionally, he raised the point of dissolution of losses and whether it would be better to do it centrally, nationally or in combination. Dr. *König* answered that there is the idea of an EU bad bank or a network of bad banks, but that she is sceptical about both. She believes that a bad bank (outsourced or established or pooled) can make sense and that this is an option to professionally work out bad loans and to gain market power. They have seen national bad banks in the past, but just because they exist it does not dissolve losses. It is questionable how to really allocate potential losses. In addition, there is already an existing and well-established market for bad loans. This seems to be found as the magical solution that allows better pricing and avoids any losses, but that is not going to happen. She expressed a lot of scepticism. In her eyes, clarity, transparency and good risk management is a prerequisite for what needs to be done.

Also, Mr. *Pier Mario Lupinu*, member of the Young Researchers Group of the EBI, asked Dr. *König* to develop on where the SRB stands with regard to legal liquidity after resolution. Prof. *Ringe* then extended this question and asked where also the ECB stands in that regard.

Dr. *König* said the entire resolution framework had been overly optimistic in terms of liquidity in resolution. Funds with 60 billion Euro or more are not "peanuts". But if a very big bank is in trouble and is draining the fund just for its liquidity, it is unanswered how to provide additional liquidity and how to do it in a neutral way for the public purse. With regard to the SRB the easiest way would be addressing the ECB which can reliably provide liquidity. On the other hand, it would be possible to find liquidity based on a first loss guarantee from the fund, but this leads back to the treaty concern. This topic is still pending, Dr. *König* concluded.

Afterwards, Prof. *Gortsos* asked whether she could elaborate more on the harmonisation of insolvency regimes at EU level, as in his eyes this is an aspect of primary importance for the SRB. Dr. *König* replied that they have been arguing about this topic with the EC and the Council for a while. There is a resolution framework for the largest banks, and for the rest, national law applies. Insolvency rules vary among MS. This became clear in a case where a small bank was to be sent into national insolvency due to lack of liquidity. The ECB and the SRB decided that the bank is failing or likely to fail but there was no public interest to resolve it and that the national insolvency should be decisive. The national resolution authority not sure how this should be done, as insolvency criteria was not fulfilled under the national insolvency law. Therefore, she considered it to be difficult to have a unified European insolvency system. Nevertheless, she conceded, there is a European resolution framework – so why then should there not also be a European administrative bank liquidation scheme?

II. Session 5: Banking Regulation in Covid-19 – Do we need changes to our regulatory framework? by Mr. *Jose Manuel Campa*

The fifth session was opened by Dr. *Gstädtner*, who addressed a few welcoming remarks to Mr. *Jose Manuel Campa*, Chair of the EBA.

Mr. *Campa* began his speech by noting that the spread of the Corona virus had caused uncertainty in the MS. However, he also recognized that they had adapted quickly to the conditions and that the risks had been mitigated. Difficult health conditions and systemic challenges lay ahead for the EU. Nonetheless, the EU experienced a faster recovery than expected, but it will be slower next year. As long as there is not a good management of the pandemic, uncertainty regarding the economic and financial situation remains very high.

The banks have proven that they can act quickly and effectively, and the infrastructure built up over last decade has been helpful. Banks are in better shape now than they were in the last crisis and, more importantly, they are not the core or source of the crisis. He said the measures taken, such as the use of capital buffers and regulatory flexibility, were effective. The liquidity coverage ratio went close to 150%, but banks benefited from better conditions. Mr. *Campa* noted, that there had been a small disruption in the funding markets, but it quickly recovered. These measures have generally helped further lending to customers and readjusting customer needs.

Apart from that, Mr. *Campa* said that there has been an operational resilience that banks have gone through. One could also have been very sceptical about the technical aspect. But the transition worked relatively well. Banks have been able to maintain costumer service remotely.

Notwithstanding all this, it is important to remember that the vulnerability of banks has been accelerated in the pandemic. First, the lack of profitability will remain and perhaps become even greater. Second, with regard to the technological transformation, banking services industries have been affected by technology and banks have been upgrading their businesses.

For the medium-term horizon and medium-term capacity, the adjustment required was significant which is why this trend needs to be continued. This supposedly is also a profitability challenge. In the medium and long term, the transformation of the industrial structure and collective structure of the EU economies is already on the agenda which is also challenged by ESG.

Additionally, banks need to support the economy and therefore adequately assess the risks in their portfolios. So far, there has not been a significant increase in NPLs on banks' balance sheets but there are early signs. The stress tests from 2018 will be conducted in 2021. The development of banks is supposedly a fundamental aspect. The second aspect, Mr *Campa* said, is to what extent the regulatory framework was adequate to provide support to deal with the situation. He asked if there were areas where the system was not functioning properly or if there were amplifiers for shocks. In his view, the framework has been quite supportive so far and the last ten years in particular have been adequate. Overall, the prudential and regulatory framework has been useful but there are potential risks in some areas. The latter is true with regard to the usability of capital buffers. Reportedly, there is concern in the sector about using the buffers because of the stigma associated with it.

In summary, he concluded that the regulatory framework has been helpful and has put banks in a better situation. At the end of the day, it is important to ensure that banks are addressing long term strategic targets.

Again, this key-note speech was followed by a question session, which was started by Dr. *Gstädtner*. He outlined that Mr. *Campa* considered the existing regulation of the banking industry has proven effective during this current crisis and wanted to know if he could share his views on why he thinks it was effective. Further, Mr. Gstädtner added if in Mr. *Campa*'s view there is any scope for improvement in a specific area or a lesson learned.

Mr. *Campa* replied that the starting position of banks in terms of capital and liquidity was and is better. Additionally, with regard to sufficient flexibility, macroprudential and systemic buffers, potential procyclicality and the implementation of IFRS 9 rules both regulation and guidance given by regulatory and supervisory authorities has shown that is has been done properly. Lastly the regulatory reluctance with buffers must be decreased. Large parts of the regulation are designed for specific situations rather than macro shocks, he added.

Afterwards Prof. Dr. *Matthias Lehman* raised the point that it is well known that IFRS 9 sets out a framework to determine the amount of expected credit losses (ECL) that should be recognized. This requires, he added, the ability of entities to assess changes in the risk of a default occurring over the expected life of a financial instrument. Changes in economic conditions should be reflected in the scenarios applied by entities and in their weightings. The current Covid-19 situation is creating several economic conditions that should be considered. He wanted to know whether the current situation will prevent an application of IFRS 9 which will be too pro-cyclical.

Mr. *Campa* replied that a big part of the challenge is uncertainty. In the context of all measures, life expectancy and valuation of positions should be taken into account. Banks need to take into account and closely monitor measures that affect their depositions. At last, Mr. *Campa* concluded, IFRS 9 has not been an undesirable procyclical factor so far.

Dr. *Gstädtner* then kept on asking, a bit more general. IFRS 9 is the product of the last financial crisis, he said. Another tool which was introduced after the GFC was the bail-in tool. Sometimes one could get the view, that these tools are working for idiosyncratic events but are pro-cyclical in a systemic crisis. He asked for Mr. *Campa*'s view in this regard. Further he wanted to know if these tools worked as hoped for in a crisis like the Covid-19 one.

Mr. *Campa* acknowledged that this tackles a lively debate. Now there is already a huge macro shock affecting more sectors, he said. But macro buffers are not evenly distributed across the EU and effectiveness was not homogeneous. He admitted that these measures have been designed for specific bank situations. Nevertheless, the bail-in tool is not questioned, and a proper assessment needs to be made.

Prof. *Lehman* then continued, that the EBA has been working hard during the first Covid-19 wave to provide the necessary flexibility and certainty on the regulatory framework in the banking sector. During these first months the EBA has been monitoring the situation related to the ability of banks to keep on providing lending. If the second Covid-19 wave hits the European society and economy in a radical manner, he asked, what else can we expect from EBA. Further he asked, if the European regulation is out of ammunition.

Mr. *Campa* stressed that they are carefully monitoring the situation and that the regulatory framework is in place and ready for adjustment. But there needs to be monitoring first and that they are trying to assess the situation of the industry. For example, there is a new reporting template for banks and a new exercise to find out the status of banks' balance sheets. He also mentioned the stress test which has been postponed to 2021 and he hopes that this is going to be a useful tool.

Lastly, Dr. *Gstädtner* noted, that over the last years, European banks have made significant progress to reduce NPLs. After the current crisis started some were asking to adjourn any further NPLs work. He asked Mr. *Campa* whether he believes there is a need to rethink the current regulatory framework for NPLs.

In his answer, Mr. *Campa* mentioned that the previous regulation is effective. NPLs have been reduced by half in the past. Nevertheless, in his opinion, it is time to focus on NPLs and not to relax and that it is necessary to continue working on them. For example, EBA is going to adjust templates and work with the EC to try to foster the possible sale of NPL assets.

III. Session 6: The European Parliament's (ECON Committee) response to the Covid-19-crisis by Mr. *Markus Ferber*

The last session of the second day of this second Policy Conference was held by Mr. *Markus Ferber*, member of the ECON Committee and the European Parliament.

After some introductory words of Dr. *Gstädtner*, Mr. *Ferber* stated that Covid-19 has changed every part of our lives. It is supposedly one defining theme in Brussels. At the same time, Mr. *Ferber* noted that the measures taken after the last crisis 10 years ago led the EU to a stronger financial sector with stricter capital requirements and a BU with joint supervision and resolution. In general, he said, banks are in a strong position and therefore part of the solution, which is different to the last crisis.

Mr. *Ferber* highlighted that the EU stepped out of their way and quickly created flexibility, a robust fiscal stimulus and ESM credit facilities. Also, the short-term working scheme and the 750 billion Euro recovery package are remarkable. In his eyes, this also applies to targeted relief, such as the CRR quick fix, which has led to capital being freed up for lending to the real economy and banks being able to increase lending.

Additionally, he addressed non-performing exposures. Not all of those loans will be sufficient to turn around struck companies and the rate of NPLs will increase in the second wave, he said. In some MS the crisis of 10 years ago is still noticeable. The fact that the EU legislator already introduced a prudential backstop is a good starting point in Mr. *Ferber*'s eyes but at the same time only a backstop and not a solution.

A solution must still be found to get NPLs off the balance sheets. The European Parliament has not taken a position on the NPL topic. Regarding the idea of bad banks or AMCs, Mr. *Ferber* noted that there are prominent proponents of this idea. And he acknowledges that there is a point, as there is evidence from the last crisis, that countries with bad banks were often faster in cleaning up bank balance sheets. He then drew attention to a realistic solution being on a national level and that a unified European bad bank will realistically not happen. However, he raised the point of an alternative network of AMCs, which seems to be more promising in his eyes. He outlined one key point which is supposed to be conditionality. There must be access to the scheme only for those companies that had a viable business model before the covid-19 crisis. But in any case, Mr. *Ferber* said, this would be just one part of a large toolkit.

He finally turned to the Basel III finalisation and its implementation. From a European point of view, Mr. *Ferber* finds parts of it disappointing and thinks that this would bring a bad outcome for EU banks, leading to a competitive disadvantage. Therefore, he pleaded for reconsidering the Basel package. There is no need for a 1 to 1 implementation but rather a good fit has to be found. He believes that the first question is whether the EU has to implement each and all provisions for each and all banks. This would be the case for SSM banks, but he doubts whether this applies to all private banks too. Frankly, this should not lead to a regulatory race to the bottom but to an approach that serves European interests.

Dr. *Gstädtner* then addressed the CRR Quick Fix and what it tried to achieve due to the Corona crisis. Now, he said, we see the crisis to go into another phase due to the second lock downs in many countries in Europe. What else could the EU do in this field in order to further mitigate the impact of the crisis?

Mr. *Ferber* said, when speaking about the CRR, the question is what can be done quickly, easily, and uncontroversial. There is no ground for a second quick fix and one has to look for adjustments in other areas, such as the Basel III implementation, non performing exposures or a functioning framework for secondary markets for NPLs.

Dr. *Gstädtner* went on to IFRS 9 and the bail-in tool and asked whether this is more problematic in a crisis like this. He wanted to know Mr. *Ferber*s point of view with regard to this or whether he sees a need for adjustment.

Mr. *Ferber* replied that the post crisis financial market regulation left the EU in a good position. In this crisis, he added, banks are part of the solution which was the other way around 12 years ago. Also, idiosyncratic problems need to be addressed and identified.

Dr. *Gstädtner* subsequently tackled the NPLs and said that some commentators have suggested to pause the rules for NPLs which have been introduced in the last years in order to ask banks to deal with them earlier on. He wanted to know what Mr. *Ferber* thinks about such ideas.

Mr. *Ferber* said, that NPLs are not only a short-term problem for banks but also a long-term one for financial stability. Nevertheless, bad banks can help address these problems if they are properly designed. But, again, this is always linked to national insolvency and tax law. Mr. *Ferber* added that there is no European approach so far.

Dr. *Gstädtner* then stressed the idea of linking access to any AMC to a viable business model. Most banks in Europe deliver a RoE under their CoR, for the last 10 years. This is obviously first of all an issue that banks need to address. However, is there anything that the European legislator can do in order to help banks to work on this issue.

Mr. *Ferber* argued that the ECB is not changing politics. Although he did not believe that the EU was overbanked, banks have to think about their business models. This is true with regard to digitalization. From the political point of view the leverage is compliance costs. The banking system arrived stable which is a huge success but there is no sign that compliance costs can be reduced. Therefore, Mr. *Ferber* added, one has to look deeper, e.g., lighter reporting requirements for smaller institutions or issues on MiFiD. He believes that the market will demand this.

Dr. *Gstädtner* raised a question of one of the participants on whether the EP should be able to delay the implementation of the Basel rules.

Mr. *Ferber* acknowledged that this is a difficult question but that it's not the time to do this now. Currently there is another study on the impact on the banking sector that is about to be finalised. They are looking very closely, he said, to see if it fits the European and not only the US way.

Last but not least Dr. *Gstädtner* asked Mr. *Ferber*, if he thinks that the recovery fund is going to be a permanent instrument as some already propose and/or if it should be one.

Mr. *Ferber* concluded that this is only a temporary solution for a special moment. The European government debt is guaranteed by the MS. However, he also noted that there is an appetite for a European product, but in his eyes, debts on all levels, and additionally on EU level, will not work in the long run. Adding just one more level is not solving the problem. Eventually, everything has to be repaid and there is not going to be a zero-interest rate all the time. Finally, when money becomes more expensive debts will become a real threat. Mr. *Ferber* pinpointed that a short time solution is not always sustainable in the long term.

D. Concluding Remarks

In his concluding remarks, Dr. *Gstädtner* thanked all participating speakers and the audience for this conference. The conference showed that there are currently many different developments ongoing in the banking sector which make it very difficult to predict exactly the outlook for the midterm future. In any case, the conference showed that the banking system entered into this crisis in a much better shape than 10 years ago before the sovereign debt crisis. Banks are now in a better position to continue to support the economy. The crisis also showed that national and European authorities cooperated much better in this crisis compared to 10 years ago and were now able to device a toolkit in the area of banking regulation, banking supervision and monetary policy which complemented the enormous fiscal support packages launched by the MS of the EU directly or in the form of the Recovery Fund on an EU level. In particular in the Eurozone, the SSM showed its clear advantage as compared to the more nationally driven approach in the past.

Finally, Dr. *Gstädtner* also thanked the *Stiftungsprojekt Kapitalmarktunion* for their support in this conference.