Financial Stability amidst the Pandemic Crisis: On Top of the Wave

Edited by Christos V. Gortsos
and Wolf-Georg Ringe

EBI European Banking Institute

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* Cover page: *The Plague of Ashdod* (1628-1630 ca.) by Nicolas Pussin.

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2021

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Introduction by the Editors

The pandemic crisis, which broke out in early 2020, is still affecting human lives and economic activity around the globe, causing unprecedented transformations which were not foreseen just before its onset. The European Union, its citizens and the financial and non-financial firms active therein have also been negatively affected (albeit to a varying degree).

Nevertheless, unlike in the two previous, most recent economic crises, namely the 2007-2009 Global Financial Crisis (GFC) and the 2010-2018 sovereign debt crisis in the Eurozone, the impact on the stability of the EU financial system has been comparatively mild so far. This is due to several reasons: most importantly, the root-cause of the pandemic was not attributed to any sector of the financial system but originated in the real economy. Further, the financial regulatory framework had become much more robust in the meantime (albeit also much more complicated to comply with), credit institutions in particular are better capitalised now than in 2008, with (almost across the board) lower ratios of non-performing loans (NPLs) and significantly stronger liquidity, while financial supervision has also been enhanced and the macro-prudential financial framework adopted in the wake of the GFC was fully activated. Finally, many EU Member States and the EU itself acted decisively, and proactively pumped billions of Euros of support programmes into the real economy to prevent an economic meltdown.

During the last 15 months, national and EU institutions and agencies have orchestrated their efforts towards establishing an appropriate framework in order to primarily support those parts of the population and of the businesses most severely affected by the pandemic and to contain its negative effects. This included a combination of fiscal policy, monetary policy and financial policy measures; new instruments and rescue funds were introduced, flexibility in the application of several existing rules has been applied to the extent necessary and feasible, and some 'quick-fix' legislative actions supplemented the pandemic crisis management toolbox.

When we published the first edition of this EBI e-book in May 2020 ('*Pandemic Crisis and Financial Stability'*), the world seemed to be on the brink of collapse. Reflecting the positive developments over the past year, this second edition supports a more optimistic approach on the further evolution of the pandemic. Entitled '*Financial stability amidst the pandemic crisis: On top of the wave'*, the key assumption is that the various infection waves of the crisis will not be followed by another severe one, as we are gradually reaching a much-desired point of 'new normality'. And yet, we are 'on top of the wave' of the crisis as a whole, as our book title suggests. Therefore, challenges in relation to financial stability should not be underestimated, especially in (but not limited to) the field of NPLs, a new wave of which is emerging due to the impact of the pandemic on the businesses and households mostly affected. Furthermore, accommodating monetary policy measures, conventional and unconventional, fiscal stimuli and temporary financial measures will be lifted as well, meaning that several safety-net components embedded during the pandemic in the institutional and regulatory framework will cease to support economic (including financial) activity in the steady state. In addition, the discussion on the challenges linked *inter alia* to climate change is in the current constellation more focused than ever before and the adoption of measures to mitigate the related risks is high on policymakers' and financial supervisors' agendas. We sincerely hope that this volume will contribute to this debate and may serve as a platform for dialogue to reflect on the right way forward.

This publication contains 17 articles, structured in 5 sections, and discussing all of the above considerations. We are grateful to all authors, most of them members of the Academic Board of the European Banking Institute, who participated in this academic work with their valuable contributions. They develop on various regulatory aspects arising from the prolonged pandemic and related to various aspects of financial stability, at a moment when the (potentially treacherous) perception is that we are close to returning to a new normal. The contributors also discuss the long-term implications for banking and financial markets, and/or arrangements for transitioning back to post-pandemic times.

We also wish to thank the President of the EBI's Supervisory Board and the other distinguished high-level policymakers who accepted to write a foreword for the book. The EBI is a wonderful forum for engaging a debate involving both academic scholars and key European policymakers. We are very grateful for the EBI's continued support.

We finally owe an enormous amount of gratitude to the excellent editorial team, including Alessio Azzutti, Maria Grigoropoulou, Pedro Magalhães Batista, Marius Oster, Christopher Ruof, and Filippo Silano.

Athens and Hamburg

19 June 2021

Christos Gortsos and Georg Ringe

Foreword

Edouard Fernandez-Bollo

It is now more than one year since the pandemic linked to the COVID-19 started to spread to the whole world and unlocked a crisis of unprecedented characteristics in modern times, both as regards its underlying drivers as the measures taken in response. At the level of the health and medical aspects that are at the heart of the problems we face, we have witnessed a stop-and-go process, where the pandemic, after receding during summer, took new forms that forced the reintroduction of precautionary measures during the autumn and winter. The essential – and surprisingly swift – pharmaceutical breakthrough that made vaccination possible is still grappling with the evolution of the disease; whereas, the situation in the countries that were first able to largely disseminate vaccines is a positive factor widely taken into account by the forward-looking sentiment of the markets. However, this sentiment is largely underpinned also by the extraordinary measures of support taken by all the authorities.

Indeed, in addition to easing the financial conditions and the extraordinary actions taken to alleviate the impact of the lockdown measures on the real economy, an extensive budgetary stimulus is already on its way to foster the recovery in the coming months. All these measures have succeeded in largely mitigating the immediate impact of the drop in business activity, which resulted in the paradox of 2020, by large the worst year for the evolution of the European GDP since the post-war period (-6.1%at EU level, but less than the -7.5% of the spring 2020 Commission forecasts). Therein, we witnessed a marked decline in the number of bankruptcies (30%, lower at the end of the year according to the IMF) and, more generally speaking, of formal defaults of debtors in many countries. This in itself is a welcome development that has helped preserve the financial stability, and that is also reflected in the individual situation of EU banks. In fact, banks' capital position at the end of 2020 is better than that at the beginning of the year, despite the provisions that were made in particular in Q2 2020, with also a level of nonperforming loans that has continued to diminish, thanks to market conditions that have allowed the continued disposal of legacy loans. But, for the way ahead, it does entail specific risks that we must be able to tackle if we want to live up to the ambitious title of this book and remain at the top of the wave. In a nutshell: we need to reach a sustainable state for our financial system, out of the emergency palliative measures.

This objective is in fact twofold: first, we need to ensure that the withdrawal of the current level of support measures – welcomed as a transition, but of course unsustainable in the long run- is carefully managed, both by the authorities and the industry. But second, we should also ensure that the steady-state that is reached afterwards will be truly sustainable.

The first part of the challenge (i.e., how to prepare and manage the withdrawal of the measures) is essentially a question of execution that will require monitoring carefully not only the evolution of the pandemic itself, but also the changes in economic behaviour induced by the reopening of the economy. As a banking supervisor, I would just underline the need to adapt the principles of prudent risk management to the specific situation created by the support measures: because these measures have largely switched off the traditional past indications of default, banks need to have a more forward-looking approach to the risk.

The second part of the challenge (i.e., how to ensure that we reach a steady-state that can be a 'new normal' compatible with Financial Stability) is, however, even more delicate. Indeed, as it implicitly requires to be able to foresee a future state of the financial system and its relation with the real economy, this amounts to a daunting task after the humbling experience of the past eighteen months. But as it is absolutely necessary, I would like to propose three points from a banking supervisor's point of view that need to be taken into account in its design [and which resonates in one way or another way in many of the contributions of this new EBI volume].

First, let me recall that a stable international framework for the carrying out of financial activities is a collective good that considerably favours financial stability. So, to fully implement, in Europe as elsewhere, the reforms negotiated after the previous financial crisis, intended to increase the robustness of the supervisory framework, should be an integral part of any new normal.

Second, we should fully recognize that in Europe, we have additional reasons to insist on the 'new' part of the expression 'new normal'. Before the pandemic, we were in an intrinsically unstable situation, with a banking system under-profitable and under-valued compared to the international peers and a global financial system that was less able to finance the development of innovation than the US or China. That is a paradox given this other characteristic of European societies: the earlier recognition, compared to both US and China, of the need to face a radical conversion of the economy as a whole to a global path of sustainability, including the climate issues. So, we need a new way of functioning that is more economical in the wider sense of the word: one that points to an increasing need for investments in innovation, digitalization, and transformation of the economy. To achieve all this, we Europeans have an important tool to use: to further European integration, triggering the economies of scale that could facilitate the funding of innovation and its development in a wider market. Finalizing the banking union and furthering the capital markets union would clearly be conducive to this objective. However, active use of the possibilities of integration offered by the present framework, particularly in the context of the digitalization trend, should also be explored.

Finally, I would like to share the firm belief that to advance to the 'new normal', banking and financial institutions should be looking to integrate into the already well-developed culture of risk management the new risks they will have to face and assume. Indeed, as supervisors, we want to foster this integration of the new risks in the process of risk recognition assessment and monitoring. Of course, we are fully aware that this is a learning process, but determination and transparency would be key in ensuring the indispensable progress needed to reach the new normal.

Edouard Fernandez-Bollo is Member of the Supervisory Board of the Single Supervisory Mechanism as representative of the European Central Bank.

Foreword

François-Louis Michaud

More than one year after the outbreak of the COVID-19, the immediate health challenge seems improving as vaccinations accelerate, and the waves of the pandemic become flatter. Those rays of optimism also start translating into economic optimism. However, as we are still in turbulent waters, we need to remain cautious. The economic recovery remains asymmetric and the European GDP below pre-crisis levels while banks, corporates and citizens alike still benefit from unprecedented public support measures. The real-life stress test continues to unfold as we try to look at the coastline behind and the open sea in front of us.

In stark contrast to 2008, banks became part of the solution during this pandemic and helped to ensure business continuity. Banks were able to play this role as they entered the crisis with high capital and liquidity levels, fewer risks, and lower non-performing loans, thanks to their and the regulatory and supervisory sustained efforts in the aftermath of the Great Financial Crisis. Moreover, the immediate and vigorous public sector response helped banks to absorb the initial shock, to remain resilient, and to continue providing households and firms with the funding they needed.

Right after the pandemic outbreak, the EBA joined the public sector efforts to allow banks to play their essential role in supporting the recovery. We provided operational relief and facilitated tailored supervisory responses. The EBA postponed its stress test, delayed consultations and supervisory reporting remittances while releasing a pragmatic approach for supervisors to carry out their annual supervisory review and examination programmes, as well as for recovery planning. In parallel, the EBA issued a recommendation on restrictions and bans on dividend payments and variable remuneration, which ultimately allowed banks to retain capital with an overall impact of about 40 billion Euros. The EBA contributed to an early implementation of a new prudential treatment for software. Our guidelines on loan legislative and non-legislative moratoria avoided any unintended reclassification in default status for debtors in temporary liquidity difficulties by issuing the flexibility provided in the regulatory framework. Meanwhile, ad hoc reporting and disclosure requirements allowed us to properly monitor efforts while, at the same time, preserving the correct measurement of risks and reliability and timeliness of risk metrics.

The combination of fiscal and monetary, regulatory and supervisory measures has shielded banks from the first-round effects of the COVID-19 pandemic and thus prevented financial stability concerns from mounting. But there are signals of asset quality deterioration on banks' balance sheets. Banks need to proceed with the early and transparent recognition of losses and provide adequate provisioning. Transparency and information disclosure in financial markets will be key to uphold trust and discipline, especially as Europe enters the phasing out of public support measures. On the monetary side, in an environment characterised by prolonged low rates, banks need to -and can- redefine their business models, footprints and income sources mix.

The pandemic has triggered a far-reaching transformation of our societies. Digital technologies have suddenly taken unexpected importance in our lives. The interaction of banks with consumers may have changed for good; payment services evolve very rapidly; new competitors start offering traditional banking-type financial services. Those are structural shifts in terms of market size, type and number of players, distribution channels. At the same time, the EU is committed to becoming carbon-neutral by 2050, and banks should equally be part of the solution to this generational task. Physical and transition risks reflected in banks' exposures and business models need to be better measured, disclosed, and assessed using a common referential. We cannot afford to remain complacent, as those opportunities and risks from digitalisation and climate change will need to be addressed while still navigating out of the COVID-19 pandemic and keeping in mind that many European banks entered the crisis facing profitability challenges. A new normality has already surfaced, and inaction is itself a risk.

If anything, this health challenge has once more stressed the importance of collaboration and coordination between authorities at the European and international level, which were able to shift into crisis mode immediately. We all need to keep investing in an ongoing dialogue. In that regard, I would like to thank the EBI for this second issue. It offers space for reflection and provides ground for discussing our common direction of travel as European citizens; therefore, it contributes to the public good.

François-Louis Michaud is Executive Director of the European Banking Authority (EBA).

Foreword

Rolf Strauch

Since the last edition of this book, there has been remarkable progress on all policy fronts as euro area countries reacted promptly to the pandemic crisis and demonstrated agility. National authorities provided crucial relief to households and firms via direct grants, public guarantees, and payment moratoria.

Efforts at the EU level complemented this: monetary and prudential easing supported banks in facilitating the economic recovery. The European Commission's SURE program provided financial assistance to the Member States to preserve employment. The EIB further facilitated corporates funding, and the ESM quickly adjusted its enhanced conditions credit line and designed the Pandemic Crisis Support (PCS) to cover health care costs. In addition, Next Generation EU, the largest stimulus package in EU history, is not only intended to boost the recovery but also make our economies more resilient and more competitive.

The supportive role of the banking sector

The banking sector played a very different role in the pandemic crisis than it did during the global financial crisis (GFC). Banks were better prepared for a downturn when the pandemic hit. As a result, they were able to play a more significant role this time in mitigating the impact of the pandemic by increasing their lending.

This was possible because policymakers and banking supervisors had learned from the past crisis, tightened up the regulatory toolkit accordingly and set a system of rules and incentives to make banks develop their risk management capabilities and decrease their risks. Thanks to these measures, banks have been increasing their capital cushions and their levels are, on average, higher than ever. The average Common Equity Tier 1 (CET1) ratio in the EU[1] at the end of 2020 reached an all-time high of 15.5% on a fully-loaded basis, a significant increase from 11.5% for 2014 year-end, following the introduction of the post-GFC capital regulations.

Banks in Europe have also improved the quality of their assets since the last crisis. Non-performing loans (NPLs), a burden on bank health and growth capacity, have significantly decreased since their peak. The most considerable improvement came from those banks with the highest NPL ratios. Overall, the NPL ratio was 2.6% at the end of 2020, a significant drop from around 8% at the end of 2014, which amounts to a reduction in volume of more than 50%.

Following the outbreak of the virus, countries and EU institutions put a number of measures in place to ensure that banks could continue to provide loans and support the economy. The banking sector will play a vital role in the recovery phase after the pandemic; fostering a sound and profitable banking sector is therefore a strategic necessity to support growth and ensure long-term stability at the same time.

[1] EBA Risk Dashboard for Q4 2020.

However, at times, the measures conceal the true health of banks and hide the pandemic's impact on profitability, asset quality and funding. Now that the vaccination campaigns are being rolled out and we are beginning to leave the pandemic behind us, it is time to shed some light on the real health of banks.

The need for a deeper Economic and Monetary Union

There are good reasons to believe that banks in the euro area will well manage this transition to the post-pandemic world. Despite the fact that the banking union is not yet completed, concrete steps have been taken to deepen Economic and Monetary Union, and banks are more robust today than ever before.

In particular, progress was made in deepening EMU through the political approval of the ESM Treaty reform. Although the Treaty reform includes several important elements, I would only highlight the ESM backstop to the Single Resolution Fund (SRF). It makes the banking union more robust without asking taxpayers to foot the bill. The ESM backstop to the SRF fills a gap in the existing architecture of the banking union by doubling the amount available for the resolution of troubled banks. When the Single Resolution Board (SRB) resolves a troubled bank in the public interest, costs not covered by the bank itself are covered by the SRF. If the SRF's resources (expected to be close to €68 billion by the end of 2023) are depleted, the SRB can tap a credit line with the ESM.

This is operationally simpler than the bridge financing from domestic sources it replaces, which is prone to amplifying national divergences. Thus, the backstop will better shield governments from being forced to rescue failing banks, causing major disruption to their economies. Although it is tricky to draw parallels between crises, it is worth recalling that the last one saw governments inject around €360 billion into banks' capital over the ten years following the crisis, excluding asset relief and guarantees (amounting to an additional €3.5 trillion in state aid).

Even though banks are currently in a better position than during the euro crisis, some banks might face problems in the future. A well-functioning resolution framework with sufficient financial resources is the best assurance for both savers and investors.

The potential role of banking union in supporting the economic recovery

Work should not stop here. Without a concerted effort to support the banking union, we risk that the crisis will widen existing divergences, exacerbating vulnerabilities across different national banking sectors and fuelling disintegrating forces. We would miss the opportunity to support growth and stability at the same time.

Several important building blocks are still missing from the banking union architecture, and these are crucial in further strengthening and preserving financial stability in the euro area. These key elements are necessary to ensure smooth functioning of the crisis management framework and finally implement a common deposit insurance scheme, thus enabling even more integration across Europe.

Given that the euro area is still recovering from the pandemic crisis and vulnerabilities remain hidden to some extent, the completion of the crisis management framework should take priority to ensure that our financial system is really prepared for the worse. More specifically, the framework needs to offer feasible options for an orderly market exit of all banks, including medium-sized institutions. In this context, it is crucial to apply the framework consistently, effectively, proportionally and in a fair manner.

Moreover, it is crucial to put in place a common deposit insurance to avoid fragmentation among countries. Some key elements could be prioritised to find common ground among member states, namely, governance arrangements to regulate operations between national authorities and a central body and the calculation of contributions and access criteria.

In this respect, the Regulatory Treatment of Sovereign Exposure (RTSE) remains a point of discussion to facilitate the transition and reduce concentrated exposures towards domestic sovereigns. Therefore, work must continue on the sequencing of incremental measures as well as on shaping a clearer view on what can be considered an excessive sovereign bond holding. A balanced solution could recognise the multiple functions of sovereign securities in the balance sheet management of banks and the shock absorption role of banks in the market.

Finally, as regards cross-border integration, strengthening the safety net through completion of the crisis management framework and introducing a common insurance scheme for depositors could help dispel concerns from host countries and enable deeper integration. A truly integrated market for banking services with fully harmonised rules, well-funded and encompassing regimes for orderly resolution - including a strong safety net for depositors - are conditions for a sound and safe banking sector in the euro area. Even more so, as we navigate the euro area out of this pandemic.

The authors of the second EBI ebook succeeded in not just matching, but even in exceeding the high quality of the first edition. This ebook provides a comprehensive overview of what we could expect after the pandemic. Moreover, the studies shed light on interesting, new or less-known aspects that might help to distinguish the most efficient and least painful path towards economic recovery. It is my hope and expectation that this ebook will provide effective guidance and become a referenced resource for all professionals dealing with the aftermath of the pandemic crisis.

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Foreword

Thomas Gstädtner

Almost 1.5 years ago, the COVID-19 pandemic hit the globe. The health crisis affected our societies in different ways. Many people lost their lives, while countries entered into several seemingly never-ending lockdowns that brought public life to a near stand-still. As a consequence, economies experienced contractions not seen since the Second World War. According to IMF calculations, the global economy shrank by 3.5% in 2020. In advanced economies, the situation was even worse. EU economies went through a recession of -6.1% in 2020 and the US economy of -3.4%. However, as bad as the numbers still look, the economic fallout of the COVID-19 pandemic has not turned out as badly as originally expected. All numbers were corrected upwards in the course of 2020, reflecting a stronger than expected momentum in the second half of 2020.

The effects of the pandemic on the banking system show a similar picture. Banks absorbed the first economic shock of the pandemic much better than initially anticipated. In this regard, it is also worth mentioning that banks coped with the effects of the economic fallout better than during the Great Financial Crisis (GFC) of 2008/2009. By the end of 2020, the average NPL ratios of European banks had not increased. This can be partly due to the government support measures which helped retail and non-financial institutions to weather this crisis. On top of this, banks remained focused on addressing the existing stock of impaired assets via NPL sales and other measures. In the COVID-19 crisis, the banks are part of the solution rather than the problem. This is one of the big differences to the GFC. The regulatory overhaul carried out by the international community following the GFC has been working. It significantly increased the resilience of the banking sector and enabled public authorities to launch a decidedly countercyclical response to the financial fallout of the pandemic in the real economy. Unfortunately, the pandemic crisis is not over yet, and the ultimate effect of the pandemic on the banking system is still to be seen. However, it is already clear by now that the reforms introduced after the GFC paid off in this first phase of the COVID-19 crisis. Banks went into the crisis with a better capital and liquidity position and had established capital buffers which were available to be used when the crisis hit.

Not only from an idiosyncratic but also from a financial stability perspective, the COVID-19 crisis caused a significant amount of stress to the financial system ever since it started in February/March 2020. However, decisive action by the central banks, banking supervisors, regulators and the Member States in conjunction with the EU Commission helped to alleviate the effects significantly. Also in this field, the crisis is certainly not over and will leave the financial system with financial stability risks. In its latest Financial Stability Review from May 2021, the ECB identified four key financial stability risks. First, it identified risks due to vulnerable asset prices. After an initial drop when the crisis started, financial markets have experienced a strong rebound since the summer of 2020 for various reasons. These include strong and decisive action by policymakers to counter the crisis, the progress made by mid-2020 in finding a vaccine and the consequential hope that this crisis will abide soon. However, this notable rebound, e.g., in some equity markets, contrasts with weak economic fundamentals in many countries. Such disconnect between markets and economic fundamentals carries with it the risk of sharp corrections in assets prices in various markets. Secondly, the ECB recognised the rising fragility among firms, households and sovereigns amid higher debt burdens. Due to the pandemic, debt levels in the non-financial private sector and the public sector increased significantly. Governments had to finance extensive programmes to support the economy, boost healthcare services, and replace lost incomes and protect firms. In combination with a stark recession in 2020, all this led to higher debt to GDP ratios across the Eurozone. If loan guarantees are drawn, sovereign debt levels could further increase. In the private sector, firms met their liquidity needs by drawing down on credit lines and by issuing large amounts of bonds. This in turn led to high corporate debt levels in many European countries. For the time being, favourable financing conditions and support schemes alleviate short-term debt sustainability concerns, but in the medium-term higher indebtedness could increase financial stability concerns. Third, the ECB considered credit losses in combination with the weak profitability of Eurozone banks. Since the GFC, Eurozone banks' profitability has been lagging behind their global peers. This in turn has been weighing on bank valuations. The pandemic crisis saw a further decline in the banks' return of equity from over 5% at the end of 2019 to around 2% in Q2 2020. Higher loan loss provisions were the main driver for this development. A weak outlook for the lending volumes in combination with vulnerabilities in the sovereign and corporate sector will be a challenge for Eurozone banks in the years to come. Finally, the ECB identified increasing credit and liquidity risk of non-banks amid renewed risk-taking. According to the ECB's analysis, also the non-bank sector could be a reason for financial stability risks due to the increased exposure of this sector to corporate credit risk and declining cash and liquid asset holdings. In addition, similarly to the banking sector, the profitability of the insurance sector is challenged too, which could be a further reason for financial stability concerns.

It remains to be seen how the situation will evolve. The picture will become clearer once public support measures are reduced or phased out, and private sector entities and sovereigns have to adjust to the new reality in a post-COVID-world. It will be crucial that underlying problems in the private and the public sector are addressed quickly and decisively because one thing is clear: public supports measures were introduced to bridge a crisis situation, but they will not help if underlying structural problems persist.

I am very happy about the publication of this second EBI ebook on Financial Stability issues in a pandemic world. It is a great success for the EBI that academics from all across Europe are participating in the current debate with such a rich body of research

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Disclaimer: The author is writing this article in his private function in the European Banking Institute. The views expressed in this article are those of the author and do not necessarily reflect those of the ECB.

SECTION I:
GENERAL OVERVIEW

1. The silver lining of COVID: the end of secular stagnation

Charles Wyplosz

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1. Introduction

For more than a decade now, the advanced countries have operated with ultra-low interest rates, even negative in the Eurozone, Denmark, Switzerland and, for a while, Sweden. Central banks have tried hard to raise inflation to their stated targets but many failed. This has been a strange world where lenders pay borrowers to accept their monies and central banks find that inflation is too low and yet are unable to lift it up.

A sizeable economics literature has been devoted to explaining the phenomenon. The most general thesis is that the advanced economies have entered a long-lasting period of secular stagnation, characterized by low growth, minimal inflation and very low interest rates. This hypothesis carries very important implications.

One implication is that interest rates will remain low. It matters a great deal for the conduct of monetary policy. Permanently low interest rates cut the room for manoeuvre of central banks when they face a cyclical slowdown. With interest rates stuck at the effective lower bound – slightly above or below zero – they have resorted to Quantitative Easing (QE), flooding the financial markets with liquidity in the hope of encouraging private borrowing but the response has been largely disappointing. The combination of ultra-low interest rates and abundant liquidity has resulted in high stock prices. Indeed, stock prices are meant to measure the present value of future dividends, discounted by the interest rate, which means that as the interest rate goes to zero, the present value skyrockets. In addition, flush with liquidity and facing near-zero returns on bonds, the financial markets have invested heavily in stocks.

More generally, investors have looked for higher returns than now low-yielding bonds. In addition to stocks, they have channelled large amounts of resources to risky assets, including in emerging market economies. Large capital flows to these countries have been a boon and fuelled growth. However risk-taking occasionally results in disasters, especially if investments are financed by borrowing. Should the secular stagnation hypothesis be proven wrong, financial stability could resurface. If interest rate in the advanced countries rise again, capital stands to flow out of the emerging market economies, spreading hardship there.

Another important implication is that monetary policy will not play the macroeconomic stabilization role that it has performed with great effectiveness before the decline in interest rates. We have grown accustomed to central banks taking responsibility for dealing with business cycles as they were anchoring inflation to their stated targets. Fiscal policy instead was seen as too complicated as a macroeconomic stabilization instrument.

Its effectiveness was sometimes considered as weak because some research concluded that the famed fiscal multiplier was low and sometimes even negative.[2] The ability to use this instrument was in doubt given the importance of political considerations that shape budgets. In fact, in many countries, there is evidence that fiscal policy has often been used in a procyclical way, amplifying fluctuations rather than moderating them, or at best acyclical, with no impact.[3]

Finally, the prospect of a long period of low interest rates has led Olivier Blanchard and others to argue that public borrowing can be expanded securely.[4] At a time when public debts have reached high levels, this policy prescription is disquieting.

This paper wonders whether the secular stagnation hypothesis is valid and proposes an alternative explanation of the era of low interest rates (Section 2). It further elaborates on that alternative explanation (Section 3) and shows that the post-COVID recovery may allow us to pass judgment on the alternatives (Section 4). It then examines how we will know (Section 5).

[2] Alberto Alesina, Carlo Favero and Francesco Giavazzi, *Austerity* (Princeton University Press 2019).

[3] See Alberto Alesina Filipe R. Campante and Guido Tabellin, 'Why is Fiscal Policy Often Procyclical?' (2008) 6 Journal of the European Economic Association 1006; Dany Jaimovich and Ugo Panizza, 'Procyclicality or Reverse Causality?' (2007) Working Paper 566, Research Department, Inter-American Development Bank; Antonio Fatas, 'Fiscal Policy, Potential Output and the Shifting Goalposts' (2019) 67 IMF Economic Review 684; and Bram Gootjes and Jakob de Haan, 'Procyclicality of fiscal policy in European Union countries' (2020) Journal of International Money and Finance, doi.org/10.1016/j.jimonfin.2020.102276.

[4] Olivier Blanchard, 'Public Debt and Low Interest Rates' (2019) 109 American Economic Review 1197.

2. The secular stagnation hypothesis

2.1. The hypothesis in a nutshell

The case for secular stagnation has been made forcefully by Larry Summers.[5] Initially proposed by Alvin Hansen in the wake of the Great Depression this theory posits that savings are too large, or consumption is too low.[6] Weak demand limits growth, which eliminates inflation pressure. Excess savings depress interest rates. Productive investment is not buoyed by low borrowing costs because of slow growth. Hansen emphasized a declining demography, which would lead people to raise savings to provide for old-age retirement as fewer young people would provide for their late years. While also mentioning demography, Summers and others list a number of additional causes.

One reason for higher savings is that new financial regulation adopted after the Global Financial Crisis has forced banks and other financial institutions to restrict lending. This, in turn, reduces consumption and investment spending. Regulation has also led financial institution, including insurance companies, to acquire large amounts of safe assets, which are in insufficient supply, leading to low interest rates.[7] Another reason is that rising wealth inequality has transferred purchasing power to the rich, who save much more than the poor.[8] Summers also

[5] Lawrence Summers, 'Demand Side Secular Stagnation' (2015) 105 American Economic Review: Papers & Proceedings 60.
[6] Alvin Hansen, 'Economic Progress and Declining Population Growth' (1939) 29 American Economic Review 1.
[7] Ricardo K. Caballero, Emmanuel Fahri and Pierre-Olivier Gourinchas, 'The Safe Assets Shortage Conundrum' (2017) 31 Journal of Economic Perspectives 29.
[8] Atif Mian, Ludwig Straub and Amir Sufi, 'The Saving Glut of the Rich and the Rise in Household Debt' (2020) CESifo Working Paper Series 8201.

observes that the cost of technology-driven productive investments has declined.[9] This means that firms need to spend less on this kind of investment to produce a given volume of goods or services.

2.2. Testing the hypothesis requires time

Secular stagnation is a hypothesis. It has been widely accepted as a description of the current situation. The reason seems to be that it matches some stylized facts, but so do other hypotheses. The problem is that formal testing is nearly impossible because many things may be happening at the same time. For example, it is true that the price of productive equipment that heavily uses information technology has declined because innovations keep lowering the costs of production while performance is rising (think of computer chips). However, in the past, such technological advances have triggered an acceleration of growth, which was sustained over decades. Examples of these innovations include the steam engine, electricity and the combustion engine, which produced the industrial revolution. In fact, Robert Gordon has recently warned us that the current 'IT revolution' is no match to these previous innovations and that its poor contribution to technological advances explains lower growth.[10] Thus, two opposite hypotheses purport to explain the same phenomenon. In order to test one hypothesis against the other, we need a much longer observation period, unfortunately.

Much the same can be said about the impact of declining demography. Recent work by Goodhart and Pradhan argues the

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[9] Summers (n 5).
[10] Robert Gordon, 'Is U.S. Economic Growth Over? Faltering Innovation Confronts the Six Headwinds' (2012) NBER Working Paper 18315.

opposite.[11] Old people will be more numerous and they dissave. The decades of low inflation are the result of a large effective increase in labour supply as China and Eastern Europe broke from economic isolation and joined the global economy, cutting wage growth. Lower future labour supply, in this view, will provoke more dynamic wage growth. It may take a couple of decades to find out.

Other disquieting issues arise. For instance, the presumed decline in savings does not appear in data for the advanced countries, where secular stagnation is presumed to be taking place. It is true, however, that savings have risen globally over the last decade or two. The proponents of secular stagnation correctly argue that, in this day and age of financial globalization, this is the correct measure. However, the increase in global savings is down to one country, China. It is explained by a host of policy choices such as income distribution that favours firms at the expense of households, financial repression, poor welfare policies (health, retirement) or central controls that encourage productive investments. These choices can be reversed, and are likely to be reversed because they slow down growth.

2.3. Doubts about the hypothesis

A major reason to be sceptical about the secular stagnation hypothesis is the data. Nearly all the papers that develop it provide the evidence of sharply declining interest rates since the 1980s. But this is the period when inflation reached a climax in most developed countries, pushing interest rates up. Central banks then shifted their policies toward bringing inflation down,

[11] Charles Goodhart and Manoj Pradhan, *The Great Demographic Reversal: Ageing Societies, Waning Inequality, and an Inflation Revival* (Palgrave Macmillan 2020).

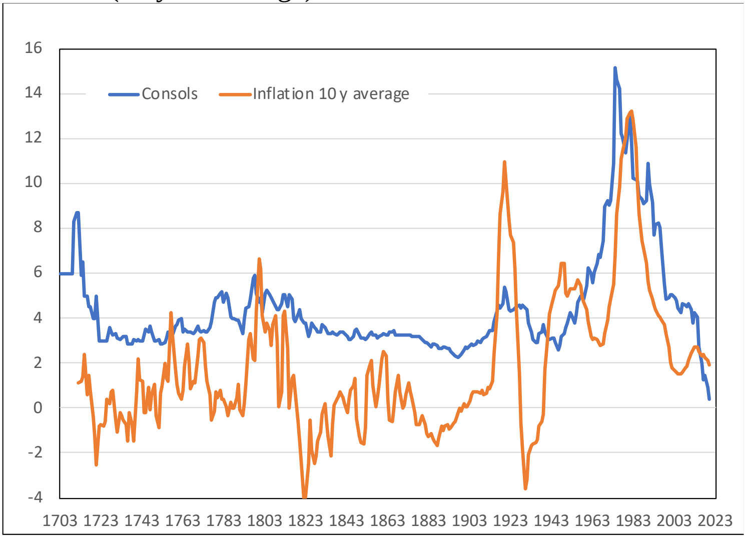
and they succeeded. As inflation receded, so did the interest rates.

The problem with this evidence is that it ignores what happened before. **Figure 1** displays the interest rate on UK consoles since 1703, probably the series that goes furthest back in time. It clearly shows that the 1980s saw a historical peak. The sharp fall that came after the peak marked a return to normality, not any new phenomenon. If anything, the interest rate stabilized in the early 2000s at a level above the historical average. However, the further decline, following the Global Financial Crisis, brought the rate to a historical low.

Figure 1 also displays the inflation rate. Given the high volatility of inflation over the 18th and 19th century, the figure presents its average over 10 years. It confirms that the peak of the interest rate during the 1980s and its subsequent decline is related to the evolution of inflation.[12] It may also be noted that the rise of global savings due to China's emergence occurred in the 2000s, long after the interest rate peaked.

[12] The previous high inflation episode corresponds to World War I.

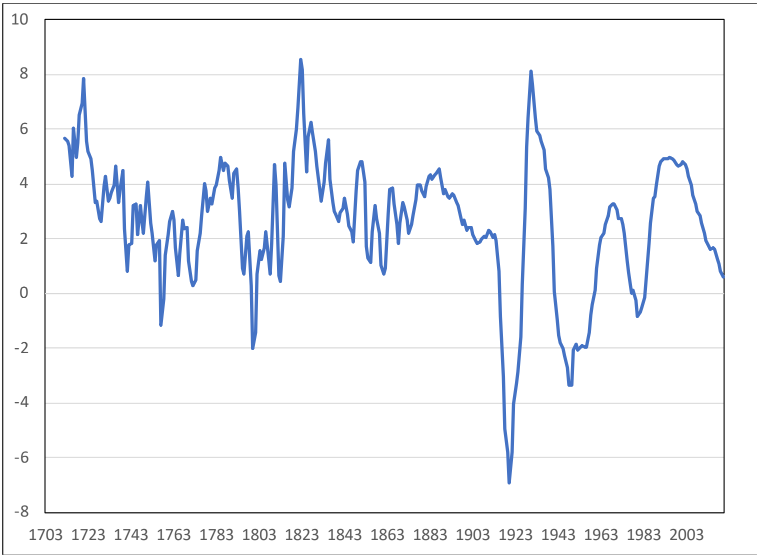
Figure 1. Interest rates on UK consols (perpetual bonds) and inflation (10 year average) 1703-2020



Source: FRED, Federal Reserve Bank of St. Louis.

An important caveat is in order. What matters for borrowers and lenders is not the nominal interest rate shown in **Figure 1**. Because inflation erodes the value of assets, they care about the difference between the nominal interest rate and the inflation rate, the real interest rate. It is displayed in **Figure 2**, using the same data as in **Figure 1**, after averaging the annual numbers over the previous ten years because the real rates were highly volatile until the 19th century. Because the interest rate has declined alongside inflation since the 1980s, the much-vaunted decline in the real rate is smaller than that of the nominal interest rate and the level reached in 2020 is not the lowest ever, far from it. In comparison with the decline in 1930s – the period that prompted Hansen to formulate the secular stagnation hypothesis – the recent experience looks trivial.

Figure 2. Real interest rate on UK consols (10 year average) 1712-2020



Source: FRED, Federal Reserve Bank of St. Louis.

3. Two theories of ultra-low interest rates

3.1. Secular stagnation

Secular stagnation predicts that interest rates are low because savings exceed productive investments, for a variety of possible reasons explained above. It may well be that, then, there is no positive interest rate that brings savings exceed investments to the same level so that interest rates must actually be negative. This, in turns, force central banks to keep interest rates low or even negative.

3.2. Monetary policy in a vicious cycle

A very different interpretation of why interest rates are currently low emphasizes the role of monetary policy.[13] It comes in two steps. The first step is the elimination of inflation in the 1980s. With prices rising in some countries at double-digit rates in the 1970s, central banks changed their strategies. They recognized that inflation cannot increase without monetary policy acquiescence, a point made much earlier by Milton Friedman. Therefore, they decided to focus on bringing inflation down. They cut sharply the rate of growth of the money supply, accepting whatever interest rate it may take, which explains the peaks of the early 1980s. As inflation receded, so did interest rates. By the late 1980s, central banks could declare victory. Then, one after another, the central banks adopted the inflation targeting strategy that still dominates even though it has been adjusted subsequently. The strategy consists in steering the short-term interest rate to achieve the inflation target, whatever it means for the money supply.

The second step starts with the Global Financial Crisis of 2008. Facing a sharp recession, which possibly could lead to a 1930s style depression, central banks slashed their interest rates all the way to the effective lower bound around zero. At the same time, they recognized their responsibility regarding financial stability and resorted to QE, both to provide financial markets with abundant liquidity and thus alleviate stress on the financial markets. They also intended to supplement the effect of ultra-low interest rates in support of growth. Furthermore, they sought to buttress the credibility of this approach by committing

[13] Claudio Borio, Piti Disyatat and Phurichai Rungcharoenkitkul, 'What anchors for the natural rate of interest?' (2019) BIS Working Papers No 777, bis.org/publ/work777.htm.

to keep the interest rates low for long. In so doing, they also tried to lower longer-term interest rates. These efforts were largely successful.

Unfortunately, in the developed countries, the governments focused on their budget deficits because they had allowed their public debts grow fast in the wake of the Global Financial Crisis. This was a premature withdrawal of fiscal policy support. It had a negative impact on growth and consequently on inflation. The central banks, therefore, were led to keep interest rates low for much longer than they initially intended. While the Fed finally raised its interest rates, still to relatively low levels, the ECB never did so, mainly because of the need to offset widespread fiscal austerity.

The result is that central banks have found themselves caught in a vicious circle, previously seen in Japan. Having reached the effective lower bound or remained close to it, they had lost the use of their key instrument, the policy interest rate. In order to counteract the perception that they run out of ammunitions, they had to reaffirm their commitment to low for long interest rates. When the COVID crisis occurred, they were largely out of the game, except that they restarted QE, primarily to prevent a financial crisis to occur on top of the health crisis. They claimed that QE was an effective substitute for the interest rate. QE may have helped a bit to stabilize the economy, but not much.[14] Fortunately, fiscal policies took over.

It seems implausible that monetary policy does not explain, partly at least, the low interest rate phenomenon. There is no

[14] Elisabeth Kempf and Lubos Pastor, 'Fifty shades of QE: Central bankers versus Academics' (*Vox EU – CEPR*, 5 October 2020), voxeu.org/article/fifty-shades-qe-central-bankers-versus-academics.

dispute that central banks control the short-term interest rate and that the low-for-long commitment – plus Japanese-style interventions along the yield curve – has also strongly influenced longer-term interest rates. These interpretations well explain the evolution of interest rates after the peak of the early 1980s as well as the further decline after the COVID crisis. The question is whether we need the secular stagnation hypothesis to complement the monetary policy interpretation. At this stage, we do not have enough evidence to answer that question. It may well that the COVID crisis will provide the needed evidence.

4. The Post-COVID test

The proponents of the secular stagnation hypothesis maintain that the interest rates will remain low and growth subdued for the indefinite future. The alternative interpretation, which emphasizes monetary policy, opens up the possibility that interest rates rise and that growth solidifies at higher levels. The likely end of the health crisis – when the coronavirus remains active but on a small scale – may tell us which interpretation is correct, or not.

The monetary interpretation rests on the observation that fiscal policies have not been used to stabilize the economy, in effect forcing central banks to carry that responsibility. During the COVID crisis, fiscal policies have promptly shifted. Budget deficits have reached scales unprecedented in peace time. They were mostly aimed at protecting people and firms during lockdowns and other social distancing measures. As these measures end, will budget deficits be promptly reduced? The risk that the economic recovery is weak or, more likely, not sustained beyond the initial bounce back, suggests that fiscal policy could remain strongly supportive of growth for an extended period, in contrast of the quick scaling-down that followed the Global Financial Crisis.

According to the secular stagnation hypothesis, these considerations are largely moot. After the initial spurt of post-pandemic growth, interest rates will remain ultra-low. If the secular stagnation hypothesis is invalid, we can distinguish four cases. They show that, in the end, it is the stance of fiscal policy, not monetary policy, that will determine what the judgment about the secular stagnation hypothesis will be. The reason is that the monetary policy interpretation presented above concerns the period after the Great Financial crisis during which governments refrained from using fiscal policy as a macroeconomic stabilizing tool, in effect forcing the hands of central banks.[15]

4.1. Expansionary fiscal and monetary policies

In this case both governments and central banks are keen to make sure that the recovery from the COVID crisis is sustained. They will keep fiscal and monetary policies supportive of growth and accept some inflation. The central banks will keep their policy rates low, raising them by less than inflation to keep real interest rates down and quite possibly negative. Even if central banks still pledge low for long policy rates, longer-term interest rates will rise because they are set by the financial markets, which will be concerned by inflation.

[15] This relationship between fiscal and monetary policies is developed at length in Elga Bartsch, Agnès Bénassy-Quéré, Giancarlo Corsetti and Xavier Debrun, 'It's all in the Mix: How Monetary and Fiscal Policies Can Work or Fail Together' (2020) Geneva Report on the World Economy 23, voxeu.org/content/it-s-all-mix-how-monetary-and-fiscal-policies-can-work-or-fail-together.

Fast growth along with higher inflation and longer-term interest rates will disprove the secular stagnation hypothesis.

4.2. End of fiscal expansion, continuing monetary policy laxity

If instead governments shift their attention to containing inflation and change the stance of their policies, firms and wage-earners could well be concerned that the recovery will be soon weakening, and they will keep wage and price increases at bay. This will be a remake of the 2010s, with moderate growth and low interest rates.

The secular stagnation hypothesis will live on, even if it is incorrect.

4.3. Expansionary fiscal policy, monetary policy moves to tightening

If it is the central banks that move to raise the interest rates while fiscal policies remain expansionary, the outcome will be high interest rates. Depending on how far central banks tighten, growth may be sustained. Even if tight monetary policies bring the recovery to an end, high interest rates will be high.

In both instances, the secular stagnation hypothesis will be disproved.

4.4. End of fiscal expansion, monetary policy tightening

Finally, if both policies cease to support the economy, growth will be slow and interest rates will remain ultra-low. This will provide support to the secular stagnation hypothesis, even if it is incorrect.

5. When and how will we know the answer?

5.1. The rise in inflation: temporary or permanent?

Inflation is already rising, chiefly because primary commodity prices and transport costs are recovering from the very low levels reached at the height of the pandemic. This is not a source of concern because it represents a return to the status quo that prevailed before the crisis. Much the same may happen for a range of goods and services, the production of which requires intermediary products that are slow to recover from the pandemic slump. Shortages will cause the corresponding prices to rise but these shortages are likely to be temporary. If all these prices stabilize and nothing else happens, we will have seen a spike in inflation rates that will soon disappear. Central banks currently claim that they do not need to take action precisely because this is their central forecast.

This benign scenario is not the only possibility, however. Inflation may rise durably for a number of related reasons. First, even a temporary inflationary spike may trigger longer-lasting inflation. As prices rise, wage-earners see their purchasing power decline and ask for wage increases. As firms face higher costs, they will need to raise their prices. This is the so-called wage-price spiral. The spiral is more likely to occur if the recovery from the COVID crisis is strong. In that case, firms will need to rapidly expand their labour forces, which will put them in a weak position to resist demands for higher wages. At the same time, facing strong demand for the products, they will be reassured that they can recoup higher costs by raising prices.

5.2. *The fiscal policy stance*

The key question for the post-COVID test concerns the stance of fiscal policies over the next couple of years. The debate is under way in Europe. The 'Next Generation EU' program adopted by the European Union represents a major institutional change but, spread as it is over several years, it is unlikely to be sufficient should growth peter out. Some governments are currently thinking about adding more national fiscal policy support.

In the US, this debate is settled. The current administration is intent on carrying out substantially increased levels of spending over the next couple of years. Two programs, one adopted in February and one currently in the process of approval, mobilize large amounts that will definitely boost growth. Another debate is whether this initial boom will raise inflation temporarily or permanently. Part of the answer to this question rests with the Federal Reserve. Under its traditional practice, the Fed should soon raise its interest rate to pre-empt a permanent increase in the inflation rate above the 2% target. However, the new monetary policy strategy of the Fed, average inflation targeting, explicitly calls for keeping inflation above target to make up for the undershooting of recent years. No one, including the Fed itself, knows how this strategy will play out.

A plausible outcome is that described in Section 4.1: years of inflation overshooting, fuelled by strongly expansionary fiscal policy and accommodating monetary policy, a combination not seen since the inflationary years in the 1970s. It seems unlikely, however, that the Fed will tolerate the return to the inflation rates seen during these years. In order to prevent such an outcome, it will have to raise its interest rate, strongly and durably. That scenario, which corresponds to Section 4.3, would likely bring to an end the era of ultra-low interest rates in the US. Both scenarios stand to invalidate the secular stagnation hypothesis since they involve continuing fiscal expansion.

5.3. Transmission from the US

The next question is whether this change would be limited to the US. The short answer is: probably not. The US economy is the largest in the world, so a rapid expansion there has a wide impact. In addition, its financial markets dominate the global financial situation. There is much evidence that interest rate changes in the US affect worldwide interest rates. Finally, the US combination of large budget deficits, tightening monetary policy and rapid growth is known to generally result in exchange rate appreciation. For other countries, that means an exchange rate depreciation, which tends to raise the inflation rate. Central banks elsewhere are likely to respond by raising their own interest rates, signalling the end of ultra-low interest rates.

5.4. Central banks and public debts

It is highly possible, therefore, that central banks are about to normalize their interest rates, returning them to historical levels as shown in Figures 1 and 2. This normalization will not come without risks, though. For instance, a rapid increase of interest rates, stands to complicate the situation of highly indebted governments that have enjoyed a long period of cheap borrowing and debt service. With public and private debts historically high in many advanced countries, pressure on central banks to show restraint is bound to grow. This could result in inflation rates significantly above the 2% norm. In that case, interest rates would still increase in nominal terms but remain low in real terms. In fact, the combination high inflation rates and relatively low real interest rates has historically been the implicitly chosen way of eroding large public debts.

Although they are independent (in the developed countries, at least), central banks will not want to be blamed for higher taxes or even public or private debt crises. They could also be concerned that raising the interest rate may provoke a sharp fall in stocks and that a strong appreciation of the exchange rate could hurt exports. The coalition of government, financial markets and exporters is formidable.

But then, keeping interest rates low while the economy expands fast will allow inflation to rise and therefore lead to low, quite possible negative, real interests, which will a boon to highly indebted governments. While this may be seen as a vindication of the secular stagnation hypothesis, it is not, since it depends entirely on central bank decisions. Yet, in that case, both camps may claim victory.

6. Conclusion

The long period of very low interest rates during which central banks have been unable to bring inflation up to their chosen target can be explained by the reluctance of governments to use fiscal policy as a macroeconomic instrument. This reluctance was largely driven by large public debts but also by the view that the fiscal instrument is not effective. This led central banks to assume alone the task of macroeconomic stabilization. In the wake of the Global Financial Crisis, they brought their interest rates down to the effective lower bound. At that stage, they had lost most of their macroeconomic firepower and inflation lingered below target.

When the COVID pandemic hit, nearly all governments forcefully stepped in. Arguably, they were foremost motivated by the need to absorb the shock that social distancing measures were creating. Paradoxically, perhaps, they may have recovered the taste for taking responsibility for macroeconomic stabilization even though their indebtedness has risen to new highs. If the governments continue support the economy, the central banks will have an opportunity of escaping the effective lower bound trap.

The advanced countries entered the COVID crisis with the pessimistic outlook of an indefinite continuation of secular stagnation. Although the pandemic has been a huge disaster in many dimensions, it will be a silver lining if, indeed, we escape this pessimistic outlook. The US seem well poised to reach that outcome. If they do, the rest of the world could well follow suite.

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2. When and how to unwind COVID-support measures to the banking system?

Rainer Haselmann & Tobias Tröger

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1. Single Supervision in the Banking Union in times of COVID-19 and beyond

The ECB-led supervision of banks in the banking union aims at the stringent and impartial enforcement of prudential regulation to safeguard financial stability and foster the single market.[1] However, the COVID-19 pandemic precipitated exceptional circumstances that induced regulators and central banks around the globe to deviate from steady-state policies, not only, but also *vis-à-vis* banks. The objective of these special measures was to enable banks to perform their critical function throughout the crisis and mitigate the looming economic downturn. Banks should continue to provide liquidity to the economy, and a

[1] Council Regulation (EU) No 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, [2013] OJ L287/63, Article 1.

credit crunch was to be avoided. The tremendous uncertainty regarding the course of the crisis and its economic impact triggered significantly larger liquidity demands among businesses.[2] Therefore, banks were granted some relief from prudential rules and standards to have more unused regulatory capital at hand to underpin their much-needed lending operations.

The realistic prospect of overcoming the pandemic when highly potent vaccines finally become available in the EU begs the question of when and how to exit the exceptional supervisory relief measures (release of capital buffer requirements and adapted reporting standards as well as acceptance of moratoria also for supervisory purposes, for details see section 2). We focus on these measures as they are the only ones that can be autonomously affected by the ECB. The key concern is to avoid procyclicality, i.e., to prevent clogging liquidity flows to the real economy and thereby stalling the economic recovery from the COVID-19 crisis. Yet, extending exceptional relief measures well into the steady state will impose significant costs on the economy as well. Insufficiently capitalised banks that only survive because forbearing supervisors do not compel adequate provisioning for pending loan losses cannot extend credit to fund a swift recovery adequately. Recent research by Jordà et al.[3] shows that economies with a weakly capitalised banking system take considerably longer to regain previous output levels after an economic shock. A closely related paper

[2] Viral V. Acharya and Sascha Steffen, 'The Risk of Being a Fallen Angel and the Corporate Dash for Cash in the midst of COVID' (2020) 10 COVID Economics 44; Moritz Schularick et al., 'Bank capital and the European recovery from the COVID-19 crisis' (2020) CEPR Discussion Paper 14927.
[3] Oscar Jordà et al., 'Bank Capital Redux' (2021) 88 Review of Economic Studies 260.

by Acharya[4] demonstrates that fiscally constrained governments in Europe often opted for supporting their banking sector through regulatory forbearance and government guarantees after the Global Financial Crisis (GFC). These undercapitalised banks loaded up on government debt and shrunk their loan books, i.e., they did not support the rebound of private investment and became a drag on the recovery.

Against this background, this chapter briefly describes and evaluates the most relevant supervisory relief measures geared towards euro area banks (section 2). It continues to model the potential impact of a pandemic-driven economic downturn on banks' balance sheets to gauge the magnitude of potential troubles the financial sector will have to cope with in the aftermath of the COVID-19 crisis. In line with prior research,[5] we find that euro area banks are likely to face a significant capital shortfall (section 3). With this in mind, we highlight ways forward that hinge on full transparency of losses and meaningful recapitalisation capacities for viable banks (section 4). We finally summarize our results (section 5).

2. Relief measures for banks in reaction to the COVID-19 crisis

Several supervisory measures seek to avoid a procyclical tightening of capital and liquidity requirements for banks during the COVID-19 crisis. Most of the relevant measures are geared directly towards financial institutions and come in the form of adapted supervisory practices, including

[4] Viral V. Acharya et al., 'Kicking the Can Down the Road: Government Interventions in the European Banking Sector' (2021) Review of Financial Studies forthcoming, doi.org/10.1093/rfs/hhab002.
[5] Schularick et al. (n 2).

recommendations regarding the application of reporting standards (2.1). Moratoria on loan repayments promulgated in Member States' legislation or based on industry-wide schemes sponsored by national banking associations also have an impact on banks' balance sheets and institutions' safety and soundness (2.2).

2.1. Direct supervisory measures

European As an immediate response to the COVID-19 crisis, the ECB adopted a capital relief policy on 12 March 2020.[6] Within the Single Supervisory Mechanism (SSM), the ECB allowed banks to temporarily operate with capital levels below Capital Requirements Regulation (CRR) and Capital Requirements Directive IV (CRD IV) requirements. Banks are allowed not to comply with Pillar 2 Guidance (P2G) until at least end-2022 and can also fully use their capital and liquidity buffers.[7] Moreover, euro area banks are also allowed to employ

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[6] ECB, 'ECB Banking Supervision provides temporary capital and operational relief in reaction to the coronavirus' (Press Release, 12 March 2020), bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200312~43351ac3ac.en.html.

[7] Several Member States gave banks additional breathing room by also releasing the countercyclical capital buffer (CCyB), the systemic risk buffer (SyRB) and the other systemically important institutions (O-SII) buffer. For a list of Member States' macroprudential measures, see ECB, 'Macroprudential measures taken by national authorities since the outbreak of the coronavirus pandemic' (19 April 2021), ecb.europa.eu/pub/financial-stability/macroprudential-measures/html/index.en.html. While the ECB has no competence to initiate such relief measures, it has the power to apply more stringent buffer requirements than adopted nationally, see SSM-Regulation, Article 5. Therefore, not interfering with Member States' supervisory relief decisions after notification indicates that the ECB agrees with the underlying macroprudential policy. This is consistent with the ECB's own decisions to grant capital relief for banks in reaction to the pandemic and thus forms part of a consistent policy response.

capital instruments that do not qualify as CET1 capital to meet the Pillar 2 Requirements (P2R). This relief in the composition of P2R was originally scheduled to come into effect simultaneously with the entry of the CRD V, i.e., the ECB accelerated the already foreseen steady state reform.

In the second round of relief measures published on 20 March 2020, the ECB delivered guidance to euro area banks on provisioning for credit risk.[8] In addition to the flexibility already foreseen in the ECB Guidance on NPL,[9] a favourable treatment of loans backed by public support measures was endorsed: even in arrears, these loans need not be qualified as non-performing. In another attempt to minimise loss recognition, on 1 April 2020, the ECB encouraged banks to apply the transitional IFRS 9 provisions foreseen in the CRR and avoid excessively procyclical assumptions in the IFRS 9 models being used to determine their provisions.[10] More precisely, the ECB encouraged a specific approach to collectively assess the significant increase in credit risk (SICR), the use of long-term macroeconomic forecasts, and the use of macroeconomic forecasts for specific years. The critical assumptions banks could factor into their forecasts with the acquiescence of the supervisor are that (i) '*a sharp rebound in*

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[8] ECB, 'ECB Banking Supervision provides further flexibility to banks in reaction to coronavirus' (Press Release, 20 March 2020), bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200320~4cdbbcf466.en.html.

[9] ECB, *Guidance to banks on non-performing loans* (March 2017), bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf.

[10] ECB, 'IFRS 9 in the context of the coronavirus (COVID-19) pandemic' (Letter of the Chair of the Supervisory Board to all Significant Institutions, 1 April 2020), bankingsupervision.europa.eu/press/letterstobanks/shared/pdf/2020/ssm.2020_letter_IFRS_9_in_the_context_of_the_coronavirus_COVID-19_pandemic.en.pdf.

economic activity could be expected once the social restrictions have been lifted', (ii) this rebound '*might occur within 2020'*, and (iii) the '*mean reversion can be assumed earlier than under normal conditions*'. We explain how credit loss provisioning under IFRS 9 potentially contributes to more procyclicality in **Box 1** below.

Box 1: Expected Credit Loss Provisioning and Procyclicality

The introduction of IFRS 9 for annual periods beginning on or after 1 January 2018 marked a significant change in the accounting rules applicable to capital market oriented financial institutions in Europe. The most drastic change relates to the provisioning of loans. While under the old accounting regime, i.e., International Accounting Standard 39 (IAS 39), provisioning requirements followed the incurred loss model, IFRS 9 introduced the expected credit loss approach. The experience of the financial crisis of 2007 and 2008 provides the rationale underpinning this switch. Supervisors and policymakers argued that banks recognised too little losses too late under IAS 39. Therefore, the Financial Stability Forum held that earlier recognition of loan losses could have reduced procyclicality during the crisis and asked the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) to improve the accounting rules for financial instruments on recognition and measurement (see Financial Stability Forum, 'Report of the Financial Stability Forum on Addressing Procyclicality in the Financial System' (2009)). In Europe, this resulted in the introduction of IFRS 9 for annual periods beginning on or after 1 January 2018.

Under the incurred loss model, banks only built up provisions once a loan experienced a credit loss event, i.e. borrowers being past due with their payments, the opening of bankruptcy proceedings or debt restructuring. Under this old regime, banks were not allowed to apply their own historic credit risk estimates to determine their accounting provisions. The innovation under the new IFRS 9 is that banks form provisions based on their internal models and credit risk estimates (see Bischof et al., 'Forward Looking Loss Provisioning' (2021) mimeo for further details). Provisions for individual loans are calculated based on a three-stage model. Stage 1 comprises all newly extended performing loans. Provisions for stage 1 loans amount to the losses expected for the next 12 months. Once a loan experiences a deterioration of credit quality (i.e., a change from an investment grade to a non-investment grade rating or a downrating by two rating notches at non-investment grade loans), a loan migrates to stage 2. For stage 2 loans, banks already write-off the expected lifetime losses, although no actual credit loss occurred at this point. Once a loan has defaulted, banks form provisions according to the loss given default of the loan (stage 3). Under IAS 39, banks formed provisions similar to these stage 3 provisions only.

The introduction of IFRS 9 introduces an enormous degree of complexity. Banks are required to determine each loan's probability of default (PD) with the help of statistical default models (similar to the model based capital regulation) as well as the exposure at default (EAD), and loss given default (LGD). At the same time, the new accounting standards also increase the amount of discretion banks enjoy in forming their loss provisions. The actual impact of IFRS 9 on procyclicality has been debated in the current literature. In a theoretical model, Abad and Suarez ('Assessing the cyclical implications of IFRS 9 - a recursive model' (2018) ESRB Occasional Paper No. 12.) show that whether IFRS 9 will reduce or increase procyclicality depends on banks' ex-ante willingness to build up precautionary provisions, as well as on their ability to foresee future macroeconomic shocks. Empirically, Bischof et al. ('Forward Looking Loss Provisioning' (2021) mimeo.) show for a sample of German banks that they strategically classified too few loans as stage 2 loans around the introduction of IFRS 9. This concealment of credit risk will amplify procyclicality in the event of a shock.

Source: own illustration based on Bischof et al., 'Forward Looking Loss Provisioning' (2021) mimeo.

However, the ECB made it clear from the outset that, even in times of distress '*[i]n exercising flexibility, the right balance should be achieved between helping banks absorb the impact of the current downturn, on the one hand, and maintaining the correct risk identification practices and risk management incentives, on the other, as well as ensuring that only sustainable solutions for viable distressed debtors are deployed*'.[11] The ECB also clarified its '*operational expectations regarding the management of the quality of loan portfolios, so that supervised institutions could take timely action to minimise any cliff effects with a clear understanding of the risks they were facing, thus enabling them to devise*

[11] ECB, 'FAQs on ECB supervisory measures in reaction to the coronavirus' (2021), bankingsupervision.europa.eu/press/publications/html/ssm.faq_ECB_supervisory_measures_in_reaction_to_the_coronavirus~8a631697a4.en.html.

appropriate strategies'.[12] In addition, the ECB adopted a couple of other measures aimed at providing banks with sufficient leeway to lend throughout the crises[13] and took a pragmatic approach in the 2020 supervisory review and evaluation process (SREP) that also sought to avoid additional pressure on banks' lending capacity.[14]

2.2. Moratoria on repayments

While the promulgation of moratoria that directly benefit corporate or retail debtors falls within the ambit of Member States' national legislation, the prudential treatment of deferred obligations eligible for such schemes remains a matter of banking regulation and supervision. The ECB also granted flexibility to the NPL classification of exposures covered by

[12] ECB, 'Macroprudential measures taken by national authorities since the outbreak of the coronavirus pandemic' (2021), ecb.europa.eu/pub/financial-stability/macroprudential-measures/html/index.en.html.

[13] ECB (n 7). The ECB allowed banks to operate temporarily below the 100% liquidity coverage ratio (LCR) requirement until at least end-2021. Furthermore, the ECB rescheduled on-site inspections and extended deadlines for remedial actions arising from recent on-site inspections and internal model investigations were extended. Similarly, the ECB also extended the deadline for complying with the supervisory review and evaluation process (SREP) 2019 qualitative measures by six months. Additionally, the ECB used the stick and recommended banks to preserve capital and liquidity and not to pay dividends or conduct share buy-backs in order to be able to support households, small businesses and corporate borrowers and/or to absorb losses on existing exposures to such borrowers.

[14] ECB, *2020 SREP aggregate results* (28 January 2021), bankingsupervision.europa.eu/banking/srep/2021/html/ssm.srepaggregateresults2021.en.html. Euro area banks also gained some leeway to master the operational challenges posed by the pandemic when the EBA decided to postpone the 2020 annual EU-wide stress test to 2021, see EBA, 'EBA statement on actions to mitigate the impact of COVID-19 on the EU banking sector' (12 March 2020), eba.europa.eu/eba-statement-actions-mitigate-impact-covid-19-eu-banking-sector.

qualifying legislative and non-legislative[15] moratoria. If a national moratorium meets the criteria set out by the respective EBA Guidelines,[16] the more than 90 days past due that determine default under CRR (art 178(1)(b)) need to be counted in light of the moratorium, i.e., the revised payment schedule devised under it. COVID-19-induced payment moratoria are not considered forbearance measures, and covered exposures need not be qualified as NPLs. However, moratoria do not suspend banks' general obligation to assess the credit quality of exposures and to qualify them as defaulting once the borrower becomes unlikely to pay (CRR, art 178(1)(a)). Put differently, moratorium schemes have to be blind regarding benefactors' creditworthiness, but banks are nevertheless expected to closely watch the solvency of individual borrowers.

2.3. Evaluation

The relief measures allowing banks to undercut P2G requirements, to meet P2R with lower quality capital instruments and to fully use buffers to cushion increased losses and meet heightened liquidity demands are fully aligned with the rationale that underpins the respective prudential requirements. Additional capital and liquidity requirements were put in place to increase the resilience of banks against unanticipated shocks and thus need to be available once a crises

[15] Industry- or sector-wide private initiatives agreed and applied broadly by relevant banks.
[16] EBA, *Guidelines for legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis* (2 December 2020), eba.europa.eu/regulation-and-policy/credit-risk/guidelines-legislative-and-non-legislative-moratoria-loan-repayments-applied-light-covid-19-crisis.

hits. Therefore, by design, capital buffers should be lower during a recession, as suggested by Holmström and Tirole.[17]

In contrast, we judge the ECB's recommendation to use highly optimistic macroeconomic assumptions in financial reporting more critically. Contrary to the projections the ECB induced banks to use for their accounting forecasts (see Section 2.1.), macroeconomic conditions did not rebound within 2020. Furthermore, even after the first quarter of 2021, there is still significant uncertainty about future economic activity in the euro area. In any case, as a matter of principle, supervisors should audit compliance with reporting standards and not seek to influence banks' respective choices. More importantly, taking a forbearing stance that allows banks to conceal a deterioration of credit quality lowers transparency. Ultimately, investors in bank capital who feel unable to assess the actual quality of the bank's assets may lose confidence in the viability of the institution and therefore start withdrawing short-term funding. The looming fragility is particularly harmful during a recession and may ultimately thwart the supervisory efforts to maintain banks' lending capacity. Finally, the lack of robust information on the actual asset quality also impedes on the effective resolution of failing banks.

In a similar vein, a broad recognition of moratoria in prudential regulation has the potential to camouflage impending losses. It is therefore important that the ECB remains credibly committed to compelling banks to assess the unlikely to pay-criterion.

[17] Bengt Holmström and Jean Tirole, 'Financial Intermediation, Loanable Funds, and the Real Sector' (1997) 112(3) The Quarterly Journal of Economics 663.

3. Impact on unwinding COVID-19 support measures on European banking markets

Our estimation on how retracting the COVID-19 support measures would affect the European banking sector cannot rely on current balance sheet information of European banks for at least two reasons. First, as pointed out before (2.1), banks do not apply the current macroeconomic scenario when determining their provisions. Thus, reported balance sheet figures do not reflect the adjustments banks may ultimately need to carry out. Second, the moratoria translate into a lower level of bankruptcies. Therefore, banks experienced an artificially depressed level of loan defaults. Once these indirect national measures expire, it is likely that loan defaults will accelerate.

Against this background, we conduct the subsequent simulation to bypass the shortcomings of noisy balance sheet information. We collect information on banks' loan portfolios and capital positions prior to the corona pandemic. Based on this data, we simulate recession shocks of different magnitudes. Doing so allows us to estimate how the corona shock would impact banks' capital ratios once the ECB unwinds the COVID-19 support measures. Before performing the simulation, we briefly assess banks' capital positions prior to the pandemic to better understand the backdrop conditions of the European banking sector.

3.1. Status of current regulatory environment and European ability to withstand shocks

Since the last financial crisis, extensive regulatory efforts – culminating in the final version of the Basel III Accord still pending implementation into European law – increased minimum capital requirements and sought to make them more responsive to macroeconomic and idiosyncratic shocks.[18] **Figure 1** below summarises the quarterly development of CET1 ratios from 2016 to the end of 2020 for European banks. As a result of regulatory tightening, we observe a constant increase in the average CET1 ratio. In December 2019, the CET1 ratio of significant institutions directly supervised by the ECB stood at 14.9%. When interpreting CET1 ratios since the outbreak of the corona pandemic, a caveat is that these figures are affected by the support measures described above. Once these are reversed, actual CET1 ratios would likely be considerably lower. In the next subsection, we aim at estimating the impact of such a policy action.

Figure 1: Quarterly developments of CET1 ratio, ECB Supervisory Review, January 2021.

Source: ECB supervisory statistics.

[18] While the final Basel III Accord's implementation is still pending, many of the reforms have been implemented since the publication of the original version of the Accord in 2013.

3.2. Impact on banks' solvency when support measured would be unwound.

We aim to quantitatively assess the impact of unwinding the current relief measures. The ECB's capital relief decision and its stance to afford banks' more leeway in setting their provisions constitute the most relevant support measures (see 2.1). Unwinding these support measures would be equivalent to ask banks to adjust their provisions to the current macroeconomic environment. Furthermore, banks would be required to comply with the full-fledged capital requirements, including buffers and P2G.

We conduct a simulation to obtain an estimate of the impact such a policy reversal may have. The data and methodology of this simulation are borrowed from a recent paper by Bischof et al.[19] Given that we have only access to micro level data of German banks, the simulation can only be conducted for this sample. However, we believe that our results can be transferred to a broader European context for the reasons set out below.

Box 2: Methodological Details of the Simulation

The sample of the simulation comprises the 64 German banks that are required to determine their provisions under IFRS 9. All listed companies in the EU were mandated to apply IFRS 9 for financial years beginning in 2018. Out of these 64 sample banks, 45 banks determine their regulatory capital requirements based on internal risk models, i.e., apply the internal rating based (IRB) approach. The remaining 19 banks operate under the so-called standard approach (SA), which uses risk weights stipulated in CRR that sometimes hinge on external ratings. The simulation aims to assess the

[19] Jannis Bischof et al., 'Forward Looking Loss Provisioning' (2021) mimeo.

impact on bank capital of a shock that is similar in magnitude to the current pandemic recession. The methodology and sample are taken from Bischof et al. ('Forward Looking Loss Provisioning' (2021) mimeo). All data items are based on Deutsche Bundesbank's supervisory data sets.

We take the pre-corona loan portfolios of the 64 banks in the sample as our starting point. Given that the corona crisis reached Europe in February/March 2020, the credit register data of 2019 Q4 constitutes the relevant pre-shock point in time. The credit register does not indicate the IFRS 9 classification of individual loans (see **Box 1** for details). To obtain the IFRS 9 classification, we use past information from the credit register. More specifically, each loan is tracked back to its origination. At origination, each new loan is classified as stage 1. If a loan is rated 'investment grade' at issuance and later obtains a non-investment grade rating, the loan will be classified as stage 2 from that date onwards. If a loan is rated 'non-investment grade' at issuance and the loan's rating deteriorates by more than one rating notch over time, it will also be classified as stage 2 from this date onwards. In the case of a loan default, it is classified as stage 3. Based on this exercise, we obtain the relevant IFRS 9 classifications for each loan in the credit register at 2019 Q4.

Next, we determine the magnitude of the recession shock. For that purpose, we cannot take the credit risk parameters of the 2020 recession because the ECB allowed banks to assume a highly optimistic macroeconomic scenario for these credit risk measures (see 2.1). **Figure 2** shows that the recession of 2009 produced a shock similar to the 2020 recession in Germany. We thus measure how credit risk parameters (i.e., PDs and LGDs) changed from 2008 Q1 to 2010 Q1. By doing so, we obtain credit risk estimates of a similar recession where provisioning rules had not been affected by permissive supervisory interference. Each loan is assigned to a rating class from AAA to D based on its PD both in 2008 Q1 and 2010 Q1. By aggregating this information from all borrowers, we obtain a migration matrix for each rating class. This matrix indicates the probability that, after the recession hits, a given loan migrates from one rating class to another. If we aggregate the migration matrix over the three IFRS 9 stages, we obtain the following values: under the scenario of the 2009 recession the probability of a stage 1 loan to remain a stage 1 loan during the recession is equal to 74.35%; the probability of a stage 1 loan to deteriorate to stage 2 is 23.36% and the probability that such a loan defaults (i.e., becomes stage 3) is 2.30%. For a loan being classified as stage 2 before the recession, there is a 26.63% probability that this loan will improve to stage 1, and a 68.32% probability that the loan will remain in stage 2; with a probability of 5.05% that the loan will default.

We now apply this migration matrix to each loan in the pre-pandemic credit register dataset. **Figure 3** illustrates how the simulated recession impacts the composition of the portfolios of stage 1, stage 2, and stage 3 loans. Banks report LGDs on the loan-portfolio level depending on the average credit ratings of the borrower. To determine the corresponding loan loss provisions (LLPs) for stage 1 loans, we multiply the share of loans with the average PD and the average LGD. For stage 2 loans, we compute the corresponding loan loss provision assuming an average maturity of three years. Since banks have to cover the expected lifetime loss, the provisions are calculated in the same way as for stage 1 loans but multiplied by three. Provisions for stage 3 loans are equivalent to the LGD. Summing up, the LLPs of three different stages provide the amount of write-offs banks have to conduct as a percentage of the total loan volume. The difference between the LLPs of the pre-shock scenario and the provisions of the recession scenario constitutes the additional provisions banks have to deduct from their equity capital as a consequence of the projected 2020 recession scenario. These values are shown in **Figure 4**.

A recession further impacts the calculation of risk-weighted assets in case banks apply the IRB approach to determine their regulatory capital charges. The main characteristics of this approach are internal default models that determine the PD for each loan. These PDs are then mapped via the so-called Basel function to determine banks' risk-weighted assets. These risk-weighted assets constitute the denominator of banks' regulatory capital ratio. We apply the migration matrix described above to the pre-corona loan portfolio to determine how the risk weight of a specific loan changes due to the recession. Of course, we only estimate the changes in risk-weighted assets for those banks whose regulatory capital requirements are determined by the IRB approach.

Source: Jannis Bischof et al., 'Forward Looking Loss Provisioning' (2021) mimeo.

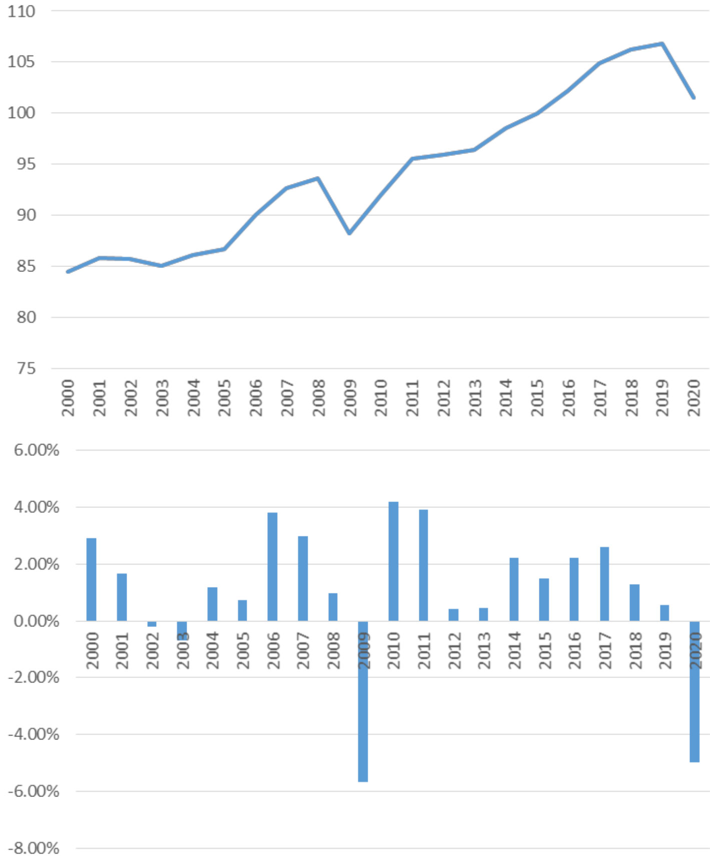
By its very nature, the corona pandemic affected the macroeconomic environment quite similarly across Europe, albeit with different orders of magnitude. According to the IMF World Economic Outlook Database, October 2020, the real gross domestic product (GDP) growth rates for the year 2020 were -9.8% in France, -6.0% in Germany, -12.8% in Spain, -9.8% in the United Kingdom, and -10.6% in Italy. Therefore, our analysis for Germany can be interpreted as representing a lower bound for the macroeconomic shock euro area economies experience due to the coronavirus pandemic.[20] We also focus only on capital market-oriented banks, i.e., those banks that are required to apply the new IFRS 9 standard to determine their provisions. This is important for our simulation since these banks are the main benefactors of the current relief measures.

The idea of the simulation is quite simple. We take balance sheet and credit register information of German banks before the spread of the corona pandemic (i.e., end of 2019 figures). In the next step, we take a historic recession that resembles the corona induced downturn. In **Figure 2**, we plot the German GDP since 2000. We can see that the 2009 and 2020 recessions are of very similar magnitudes (i.e., a drop in GDP growth by -5.7% in the 2009 recession as compared to a decline of -5.0% in 2020). Further, both the 2009 and the 2020 recession came as a surprise, given that they were caused by unexpected shocks (i.e., Lehman bankruptcy/US subprime crisis and the corona pandemic). There are several reasons why the corona recession shock is likely to be more severe than the 2009 recession. First, insolvencies in the corporate sector could accelerate once public aid programs expire (see, e.g., the moratoria discussed in Section 2.2). Thus, the current GDP figures do not incorporate potential insolvencies that may occur once the public aid programs end. Second, the recovery of the 2009 recession was very fast for the German economy, and the 2020 recession has not come to an end yet. We thus design the second scenario (factor 1.5) in which we assume that the magnitude of the downturn we will observe in the aftermath of the COVID-

[20] As explained in detail below, we also consider a recession scenario in the magnitude of 1.5 times the German recession.

19 crisis will be 1.5 higher than the one observed in the 2009 recession.

Figure 2: Gross Domestic Product Germany; 2015=100

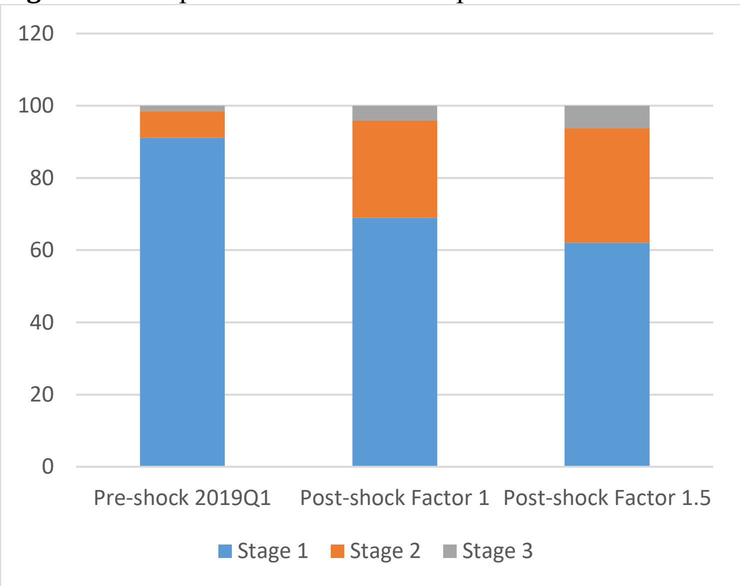


Source: Deutsche Bundesbank.

We now refer to credit register data around the 2009 recession and measure how this recession impacted loan portfolios of German banks (see **Box 2** for details regarding the methodology). While different types of loans might be affected during the 2020 recession, the aggregate impact on the rating migration is likely to be similar in any recession. The migration matrix obtained from the 2009 recession is then applied to the pre-corona loan level data of German banks. We believe our findings can be essentially carried over to the European context. The implicit assumption is that the structure of German banks' loan portfolios is similar to that of banks chartered in other European countries. While this is a fairly strong assumption, it is impossible to verify without access to loan level data. Nevertheless, we do not see obvious reasons why loan books of similarly situated public banks should be affected in a systematically different way. Moreover, the average levels of NPLs in German banks tend to be rather low by European standards. Therefore, our simulation can be considered to illustrate lower bound effects.

In **Figure 3**, we illustrate how such a recession shock would impact the composition of banks' loan portfolios. While 1.5% of all loans were non-performing in the pre-corona period, our simulation implies an increase in these NPLs (stage 3 loans) to 4.04% under the 2009 recession scenario and an increase to 6.21% if we assume the 1.5 factor shock. While an increase in NPLs is an obvious characteristic of a recession shock, it is unclear what happens to the fraction of loans that are classified as 'risky' (i.e., stage 2 loans) around the shock. If banks build up provisions in a conservative manner during good times, the fraction of these performing 'risky' loans may decrease since some of them now migrate to non-performing. If banks, however, provisioned only a few loans in good times, the fraction of performing 'risky' loans may increase during a recession. This is exactly what our simulation yields. While these so-called stage 2 loans make up only 7.35% of total loans in the pre-corona loan portfolios, this number increases drastically to about 27% for the factor 1 scenario to even about 32% for the factor 1.5 scenario. Given that banks have to write off the expected lifetime loss for these stage 2 loans, this result already suggests a strongly procyclical impact in case supervisors would demand banks to rapidly comply with the IFRS 9 rules.

Figure 3: Composition of banks' loan portfolio

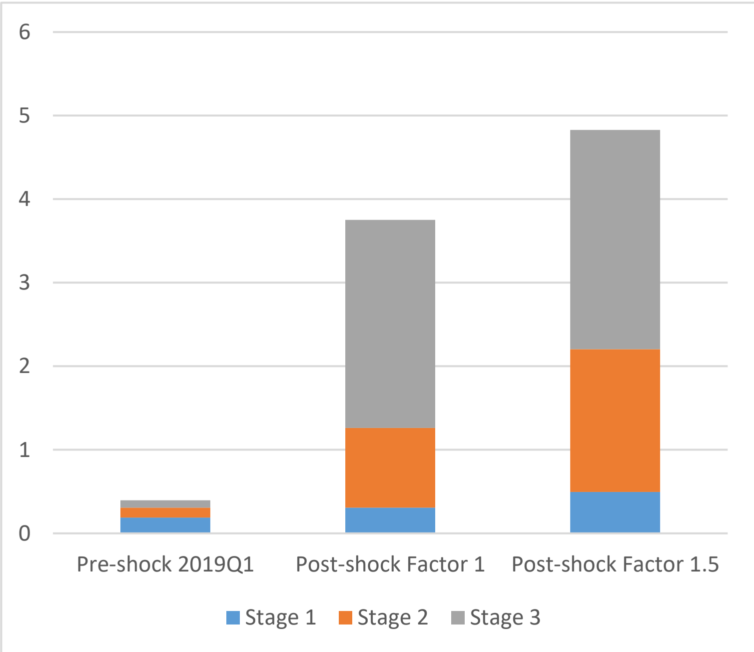


Source: Bischof et al., 'Forward Looking Loss Provisioning' (2021) mimeo, own illustration.

The impact expressed in value terms of this simulation on loan loss provisions is shown in **Figure 4**. Total provisions made up about 1% of the total loan portfolio before the corona shock, which increases to about 2.8% under the factor 1 scenario and

5.2% under the factor 1.5 scenario. The difference between these numbers is the extra provisions banks have to write off due to the recession (1.8% or 4.2% depending on the scenario).

Figure 4: Change in loan loss provisions



Source: Bischof et al., 'Forward Looking Loss Provisioning' (2021) mimeo, own illustration.

Banks' capital ratios do not just deteriorate due to provisions but also due to higher risk weights used for capital ratio calculations once credit risk parameters worsen under the internal rating-based approach. While, in principle, banks are supposed to apply through-the-cycle credit risk estimates for their internal default models, the experience of the 2009 recession is that borrowers' probability of defaults (PDs) does, on average, increase during a recession. As explained in **Box 2**, we do adjust borrowers' risk-weighted assets in a similar way as we have adjusted the provisions for both scenarios. The combined impact of the recession on pre-corona loan portfolios is summarised in **Table 1**.

Table 1: Bank capital ratios adjusted to corona shock scenarios

	IFRS 9	IAS 39
Factor 1		
Pre-shock Tier 1	17.31%	17.31%
Post-shock IRB	11.97%	13.10%
Post-shock SA	13.50%	14.79%
Factor 1.5		
Pre-shock Tier 1	17.31%	17.31%
Post-shock - Internal Rating Based Approach	8.46%	10.95%
Post-shock Standard Approach	9.57%	12.50%

Source: own calculation.

Our simulation implies a drastic decline of banks' Tier 1 ratio in the recession scenarios if COVID-19 relief measures were to unwound rapidly. Before the event, the sample banks had an average Tier 1 ratio of 17.31%. Under the factor 1 scenario and the factor 1.5 scenario, this ratio would shrink to approximately 11.07% and 8.46%, respectively.[21] In this case, a considerable fraction of bank assets would not be covered by required regulatory capital: about 16% of bank assets in the factor 1 scenario and about 42% of bank assets under the factor 1.5 scenario.

Our simulation illustrates how current capital requirements and their interplay with accounting standards amplify procyclicality once banks are hit by an unexpected shock, such as the corona recession. If banks still operated under the incurred loss model (i.e., IAS 39), the same recession shock would have resulted in considerably lower additional write-offs, i.e., a Tier 1 ratio of 13.1% and 11% for the different scenarios, respectively. Note that this finding is in line with previous literature on the procyclical impact of model-based capital regulation.[22] As shown in the last row of **Table 1**, Tier 1 ratios would be considerably higher during this recession if banks operated under the standard approach. The combination of the internal rating-based approach and IFRS 9 is a toxic accelerant for procyclicality.

[21] Our figures can be compared and are roughly in line with the ECB's corona vulnerability analysis of July 2020, see ECB, 'Euro area banking sector resilient to stress caused by coronavirus, ECB analysis shows' (Press release, 28 July 2020), bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200728~7df9502348.en.html. The ECB found for its central scenario that banks' aggregate CET1 ratio will be depleted by approximately 1.9 percentage points to 12.6%, and by 5.7 percentage points to 8.8% in the severe scenario.

[22] Markus Behn et al., 'Procyclical Capital Regulation and Lending' (2016) 71(2) The Journal of Finance 919.

3.3. Main takeaway from the simulation

Our simulation indicates that despite the currently reported high CET1 ratios of European banks (see **Figure 1**), unwinding the corona support measures would likely result in a significant deterioration of banks' capital ratios. The numbers provided by our simulation are likely a rationale for the ECB's move to encourage banks to deviate from the IFRS 9 provisioning requirements during the corona pandemic. Strict implementation of these rules would have probably triggered a new banking crisis.

However, this result illustrates the main issue with the current support measures. While temporary capital and liquidity relief measures – including those taken on the national level and acquiesced by the ECB – simply allow P2G and capital buffers to perform their intended (and expected) cushioning function in unexpected stress scenarios, lenience towards insufficient provisioning, i.e., allowing banks to deviate from IFRS 9 requirements and applying moratoria for supervisory purposes also has the potential to create severe frictions. Banks' current CET1 ratios do not reflect the actual solvency situation of these institutions. This lack of much-needed transparency creates a challenge for investor confidence and ultimately increases the fragility of the financial sector (see 2.3). In fact, we believe that looming downsides of insufficient provisioning facilitated by inadequate accounting methodologies already impair investor confidence.

4. How to unwind COVID-19 support measures

Our chapter yields several results on how the ECB should retract from its COVID-19 support measures.

In the short term, the ECB should deliver on its promise to pay attention to '*maintaining the correct risk identification practices and risk management incentives*' despite granting supervisory relief. In our view, this requires an immediate return to realistic reporting methodologies under IFRS 9. The overly optimistic macroeconomic forecasts of a fast and momentous rebound of the euro area economies in 2020 already (see 2.1) are refuted not only by the year-end data indicating a deep recession for key economies (see 3.2) but also by the ongoing lockdowns that continue to hamper economic activity in the Member States. These adequate accounting practices must also be restored to safeguard financial stability. Investors in bank capital need to regain confidence that euro area banks are forming provisions according to actual credit risks. Should the wedge between actual macroeconomic developments and the long-term forecasts used under IFRS 9 continue to grow, it becomes rational for investors to withdraw their funding for banks, thereby precipitating a banking crisis. The ECB should, furthermore, continue to support adequate provisioning by sustaining capital relief measures that allow banks to use buffers and P2G to cushion impending losses and to lend to the economy.

Additionally, we believe that the looming risk of inadequate provisioning resulting from inadequate accounting methodologies already impairs investor confidence. The ECB, joint with the EBA and the ESRB, should therefore use the opportunity of the 2021 stress test to provide a realistic account of the asset quality of euro area banks. After the publication of the methodology,[23] the macro scenario[24] and the market risk scenario,[25] the key issue will be a high degree of transparency and traceability of results to allow markets to assess banks' actual health.

In line with prior research,[26] our analysis indicates that euro area banks are likely to face a significant aggregate capital shortfall. Supervisors, resolution authorities and policymakers should not ignore this probable consequence of the COVID-19 crisis and hope for divine intervention. Forbearance will leave euro area banks undercapitalised and thus unable to fund a swift recovery from the pandemic (see section 1).

However, we believe that the current EU bank crisis management framework is in principle suited to address many of the impending problems. In fact, the corona crisis may pose an opportunity to address legacy problems of a sustained, welfare-decreasing undercapitalisation that haunted euro area banks already for a long time[27] and may ultimately lead to a welfare-increasing consolidation of the European banking sector.

Banks that have no realistic prospect of fulfilling the regulatory capital prescriptions, including combined buffer requirements (CBR) and P2G, even after economic conditions improve, should be forced to exit the market, i.e., be either put in

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[23] EBA, '2021 EU-Wide Stress Test – Methodological Note' (29 January 2021), eba.europa.eu/eba-launches-2021-eu-wide-stress-test-exercise.
[24] ESRB, 'Macro-financial scenario for the 2021 EU-wide banking sector stress test' (25 January 2021), esrb.europa.eu/mppa/stress/shared/pdf/esrb.stress_test210120~0879635930.en.pdf.
[25] EBA, '2021 EU-Wide Stress Test – Market risk scenario' (29 January 2021), eba.europa.eu/eba-launches-2021-eu-wide-stress-test-exercise.
[26] Eg Schularick et al. (n 2).
[27] Acharya et al. (n 4).

resolution or – if the public interest does not mandate the application of the special regime – unwound in a regular insolvency proceeding. The ECB and Single Resolution Board (SRB) should not limit the critical failing or likely to fail (FOLTF) determination under BRRD, Article 32(1)(a), SRMR, art 18(1)(a), to institutions that have already lost more than 50% of their own funds.[28] The fear that such a rigid application of the resolution framework could destabilise European banks seems less plausible after the ESM reform will provide a potent backstop to the Single Resolution Fund (SRF), which secures adequate resources for stabilising loss taking by the SRF. Moreover, the second prong of our proposal – to recapitalise all other banks from fiscally potent supranational coffers – will quell panic-driven contagion from the outset.

All other banks should be recapitalised following the successful U.S. example of the Troubled Asset Relief Program (TARP). First and foremost, the recapitalisation program needs to be designed in a resolution-remote manner; that is, receiving funds does not require a FOLTF assessment of individual institutions. Instead, a supranational recapitalisation fund, established as a special facility of the ESM, could acquire stakes in the largest banks of all Member States — even some healthy ones — to

[28] Cf Directive 2014/59/EU establishing a framework for for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012 (BRRD), [2014] OJ L173/190, Article 32(4)(a); and Regulation (EU) No 806/2014 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 and amending Regulation (EU) No 1093/2010 (SRMR), [2014] OJ L 225/1, Article 18(4)(a).

avoid coordination and signalling problems (i.e., a stigma for the weaker ones) and to avoid contagion.[29] Establishing such a COVID-19 specific bank recapitalization facility at the ESM would harness the fiscal firepower of this institution and ultimately that of Member States in response to extraordinary circumstances. The proposed recapitalization facility would also fulfil the overarching objective of the banking union, which seeks to break through the doom loop of mutually reinforcing banking and fiscal crises.[30] The closest equivalent to such an injection of government funds into ailing banks outside of resolution is the precautionary recapitalisation under BRRD, Article 32(4)(d) and SRMR, Article 18(4)(d). This instrument was arguably envisioned by European legislators to fend off systemic crises where creditor loss participation in resolution would prove counterproductive.[31] A recent proposal[32] takes the rationale one step further and argues for supranational precautionary recapitalisations deploying ESM funds. It thereby draws the ultimate conclusion from the ESM's new role as a pan-European backstop for euro area banks. We endorse this proposal in principle under the precondition that strict conditionality applies. Furthermore, banks should only be allowed to repay the funds received after they passed a stress

[29] Thomas Philippon and Philipp Schnabl, 'Efficient Recapitalizations' (2013) 68 The Journal of Finance 1.

[30] The ESM's facility to directly recapitalise banks was originally agreed upon with a view to exactly this policy objective (Council of the European Union 2012). We envision a narrowly restricted revitalisation of this ESM instrument which the ESM's new role as common back stop for the SRF will generally supersede.

[31] Tobias Tröger, 'Too Complex to Work – A Critical Assessment of the Bail-In Tool Under the European Bank Recovery and Resolution Regime' (2018) 4 Journal of Financial Regulation 35.

[32] Schularick et al. (n 2).

test administered by the ECB and EBA in coordination with the ESRB.

5. Executive summary

In the current crisis, public authorities took several unprecedented measures to support the economy. Importantly, EU regulators and supervisors gave banks leeway in meeting regulatory requirements. In general, temporary capital and liquidity relief measures during a recession are well justified to avoid procyclicality and to help ensure continued lending by banks. However, keeping these measures in place for too long can amount to forbearance that ultimately weakens the banking sector. The recent European experience shows that undercapitalised banks loaded up with a vast amount of government debt shrunk their loan books and thus slowed the economic recovery after the GFC. Against this background, this policy briefing discusses when and how to unwind banking supervisory relief measures.

Based on a simulation exercise, we conclude that unwinding the corona support measures would likely result in a significant deterioration of European banks' capital ratios, despite their high Common Equity Tier 1 (CET1) ratios. This implies that strict enforcement of regulatory requirements during the pandemic outbreak crisis would have likely triggered a new banking crisis, providing a rationale for COVID-19 support measures.

However, the simulation exercise also illustrates that specific supervisory relief measures, i.e., allowing banks to deviate from International Financial Reporting Standard 9 (IFRS 9) requirements and applying moratoria also for supervisory purposes, may create severe frictions as current balance sheets do not reflect the actual solvency status of banks. Such a lack of transparency creates a challenge for investor confidence and ultimately jeopardises financial stability. In fact, we believe that looming downsides of insufficient provisioning facilitated by inadequate accounting methodologies already impair investor confidence.

Therefore, the European Central Bank (ECB), joint with the European Banking Authority (EBA) and the European Systemic Risk Board (ESRB), should use the opportunity of the 2021 stress test to provide a realistic account of the asset quality of the euro area banks. A realistic account of the actual state of the banking sector is specifically blurred by overly optimistic macroeconomic forecasts endorsed by the ECB for accounting purposes. These should be revised. The ECB itself acknowledges that ‘maintaining the correct risk identification practices and risk management incentives’ is crucial, despite the extraordinary circumstances. In our view, this requires an instant return to realistic reporting methodologies under IFRS 9.

In principle, we believe that the current EU bank crisis management framework is suited to address many of the existing problems. In fact, the corona crisis may offer the opportunity to address legacy problems of a sustained and long-lasting undercapitalisation of euro area banks and may ultimately lead to a welfare-increasing consolidation of the European banking sector.

Banks that have no realistic prospect of fulfilling the regulatory capital prescriptions, even after an economic recovery, should be forced to exit the market. All other banks should be recapitalised following the successful example of the Troubled Asset Relief Program (TARP) in the US. In this spirit, a supranational recapitalisation fund could acquire stakes in the largest banks of all EU Member States. All healthy banks should be included in such a program to avoid coordination and signalling problems (i.e., a stigma for the weaker ones) and to avoid contagion. The closest equivalent to such an injection of government funds into ailing banks outside of resolution is the precautionary recapitalisation familiar from the European resolution framework.

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3. Lessons from the pandemic for European finance: A twin transformation towards green technology

Wolf-Georg Ringe

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1. Introduction

My contribution to the first edition of this volume in 2020 was characterised by the legal uncertainties around many of the strategies that were pursued at the height of the first wave of the coronavirus to safeguard financial stability.[1] I argued that the many imponderabilities that regulators and lawmakers faced in the immediate crisis response should not be influenced by an overly rigorous interpretation of legal rules. Just like in other epochal crises, I maintained, legalistic objections to economic necessities are neither warranted nor desirable.

[1] Wolf-Georg Ringe, 'COVID-19 and European Banks: no time for lawyers' in Christos V Gortsos and Wolf-Georg Ringe (eds), *Pandemic Crisis and Financial Stability* (EBI 2020) 43-62, ssrn.com/abstract=3607930.

The dust has settled now. Over is the panic-driven, immediate crisis response. It has given way to a more considerate, long-term vision on how to best cope and live with the pandemic; and more importantly still, it has been replaced with considerations on how to return to normal and improve the financial market for the future after the pandemic is over.

This contribution is taking a more forward-looking stance. Rather than looking at the past or the immediate crisis response, I adopt a perspective that explores the potential and the opportunities that emerge from the pandemic for financial institutions in the years to come. Vaccination campaigns, concerted health policies and government financial support are expected to fuel a 5.8 % lift in global GDP in 2021 after a fall of 3.5 % in 2020, according to the OECD.[2] Thriving in the post-COVID world will require financial institutions to detect and adapt to emerging realities. Two twin trends appear to emerge that will be of crucial importance for banking beyond COVID. On the one hand, the crisis has highlighted the need to accelerate the digital transformation and to explore the related phenomenon of platform thinking. On the other, COVID has put the spotlight more than ever on sustainability.

While most financial institutions have long had a digital agenda in place, its pace has largely been self-determined and flexible. The pandemic, however, has brought digital transformation to the fore and made it an urgent priority. Put more positively, the crisis has morphed into an opportunity for banks to transform into digital-first entities and to harness the power of the platform economy. Similarly, while banks have long adopted sustainability initiatives to reduce their carbon footprint and to

[2] Organisation for Economic Co-operation and Development (OECD), *OECD Economic Outlook*, Volume 109 (May 2021), oecd.org/economic-outlook.

minimise any adverse impact on society and environment, a clearly defined green strategy is fast emerging as an imperative as a consequence of the pandemic crisis. It is this challenge of twin transformation that will shape the agenda for financial institutions over the next years, and only those who will successfully link them will be successful on the global market.

This short essay explores the implications for the European financial sector in these fields. Section 2 explains how the immediate crisis response measures were not as problematic as they had been perceived initially. Instead, as Section 3 shows, the twin challenges of the crisis become more visible by the day. Section 4 discusses these two challenges, namely sustainability and digitalisation. Section 5 explores the possibility of linking the two. Section 6 concludes.

2. Legal problems of the pandemic: all solved now?

Safeguarding the European financial market during the pandemic has involved a number of legal challenges, which I discuss in my contribution to the first edition of this volume.[3] One year further down the road, the major legal battles on the centrepieces of the pandemic-fighting architecture have not been fully dispelled but look rather as if they will be resolved without further serious conflict.

Among the key crisis reactions were the establishment of a new bond buying programme by the ECB, the Pandemic Emergency Purchase Programme (PEPP). I predicted last year that the PEPP would become a likely target for legal challenge, probably at either the European Court of Justice or the German

[3] See Ringe (n 1).

Constitutional Court (GCC).[4] This is exactly what happened: in early March 2021, a group of leading EU critics filed a legal complaint at the German *Bundesverfassungsgericht*.[5] The same fate happened to the ambitious recovery project 'Next Generation EU', allowing the EU to issue debt in its own name for the first time, essentially leading to a joint EU fiscal capacity. The ratification of its centrepiece, the so-called 'Own Resources Decision'[6] was predictably also challenged in court.[7]

And yet it seems that the courts will eventually give green light to all of these rescue and recovery initiatives. The injunction request against the Own Resources Decision was rejected in April 2021.[8] While this does not anticipate any decision in the main proceedings, the Court indicated on several points that it is not convinced of the claim in substance.[9] There has not been any decision on the PEPP programme yet, but there are suggestions that the Court will ultimately not object to the ECB's plan, due to its emergency nature.[10] Finally, the controversial German 2020 rebellion against the ECB PSPP

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[4] Ringe (n 1) 54.

[5] 2 BvR 420/21.

[6] Council Decision (EU, Euratom) 2020/2053 of 14 December 2020 on the system of own resources of the European Union and repealing Decision 2014/335/EU, Euratom, [2020] OJ L424/1.

[7] The motion was brought by a group called *Bündnis Bürgerwille* ("Citizen's Will Alliance"). See Guy Chazan, 'Germany's highest court blocks ratification of EU recovery fund', (*Financial Times*, 26 March 2021), ft.com/content/74841ea6-4fbf-4c7a-b015-66ba191ffc9b.

[8] Bundesverfassungsgericht, decision of 15 April 2021 – 2 BvR 547/21 – ECLI:DE:BVerfG:2021:rs20210415.2bvr054721, bverfg.de/e/rs20210415_2bvr054721.html.

[9] ibid at paras 95 ff.

[10] Lead claimant Bernd Lucke himself has stated that the judges are likely to "wave through" the PEPP agenda because of its emergency character. See his statement on Facebook on 22 December 2020, facebook.com/BerndLuckeMdEPaD/posts/3684449064911654.

asset purchase programme that sent shockwaves through the EU financial system has also calmed down now. The stand-off between the German Constitutional Court and the ECB has been solved in a pragmatic way, and in April 2021, the GCC struck down two applications that had sought to further enforce the 2020 decision.[11]

The emerging stance on these legal controversies thus is a step towards a pragmatic handling of the crisis and a confirmation of my earlier view that legal rules have to be interpreted generously in the light of an economic emergency.[12] Indeed, it is one of the key lessons from EU financial integration that politics and economics frequently trump formal legal rules. The EU legal system has proven to be particularly malleable during the process of building an EU financial market. This became apparent during the 2008/09 global financial crisis and the ensuing 2010-12 sovereign debt crisis. One of the central tenets of policymakers, regulators and supervisors has always been to put economic necessities over formal legal problems. As The Economist put it back in 2016, 'Given a choice between financial stability and the rule book, ditch the rule book'.[13]

In a similar vein, I noted last year that the many decisions concerning state aid measures would probably be challenged; and I suggested that, again, those challenges would and should be unsuccessful. I was correct, here again. The first court decisions have now been handed down. On 17 February 2021,

[11] Federal Constitutional Court, Order of the Second Senate of 29 April 2021 (2 BvR 1651/15 and 2BvR 2006/15), bundesverfassungsgericht.de/SharedDocs/Entscheidungen/EN/2021/04/rs20210429_2bvr165115en.html (in English).
[12] Ringe (n 1) 56-59.
[13] The Economist, 'The Rule of Flaw' (12 May 2016), economist.com/leaders/2016/05/12/the-rule-of-flaw.

the General Court of the European Union dismissed Ryanair's challenges to pandemic aid packages introduced in France and Sweden that sought to support their respective domestic airline sector.[14] The decisions are the first ones where the General Court has decided on the legality of the State aid schemes adopted in response to the pandemic. While both decisions are still under appeal to the CJEU, they set an important first mark on the likely perspective the judiciary will take on these and other cases. Meanwhile, the European Commission has adopted already its fifth amendment to the Temporary Framework, extending it further until the end of 2021.[15] More than 200 individual schemes and national measures have been cleared under this framework since the outbreak of the crisis. Commentators judge the scheme a success.[16]

To cite one final example, plans for a European 'Bad Bank' that were severely criticised in 2020 have now won over a growing number of supporters. The plan to erect a Bad Bank or Asset Management Company is certainly legally very controversial and may violate both competition law principles as well as the EU resolution directive BRRD.[17] Despite these concerns,

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[14] Cases T-259/20 and T-238/20 *Ryanair DAC v European Commission* ECLI:EU:T:2021:91 and 92.

[15] EC, 'State aid: Commission prolongs and further expands Temporary Framework to support economy in context of coronavirus outbreak' (Press Release, 28 January 2021), ec.europa.eu/commission/presscorner/detail/en/ip_21_261.

[16] Johan Ysewyn and Sophie Bertin, 'The Commission Publishes the Latest Extension of the Temporary Framework for State aid measures to support the economy during the Covid-19 outbreak' (15 February 2021) Covington Competition, covcompetition.com/2021/02/the-commission-publishes-the-latest-extension-of-the-temporary-framework-for-state-aid-measures-to-support-the-economy-during-the-covid-19-outbreak.

[17] Ringe (n 1) 47. See Centrum für Europäische Politik, 'Notleidende Kredite und Corona' (23 March 2021) cepAnalyse No 5/2021, cep.eu/eu-

several prominent policy makers and commentators are now supporting the plan, making its adoption likely in the months to come.[18] In a hearing before the European Parliament, Andrea Enria, Chair of the Supervisory Board of the SSM, defended the plan.[19] In a move to seek compromise, he suggested in a recent op-ed to soften down the plan and establish a network of regional AMCs instead.[20]

The bottom line is, and has always been, that legal rules and solutions can be surprisingly flexible when faced with a serious crisis. We should therefore expect that political choices will, by and large, be implemented and can, for the most part, be reconciled with the present EU legal system. It is against this backdrop that we now turn to discuss future challenges for the legal system.

3. Towards a past-pandemic agenda of twin transformation

The immediate heat of the crisis with its hectic implementation of emergency measures lies behind us. To be sure, there will be many challenges in returning to the new normal. When and how to unwind government support measures is one controversial

themen/details/cep/notleidende-kredite-und-corona-cepanalyse-zu-com2020-822.html.

[18] See, for example, Andrea Enria, Chairman of the supervisory board of the European Central Bank, 'ECB: the EU needs a regional "bad bank"' (*Financial Times*, 26 October 2020), ft.com/content/cc3a9a51-4d9a-4c73-9ff0-9f623ecf4065; Antonio Carrascosa, Former Board Member at the Single Resolution Board, 'A European Bad Bank – a necessary tool for financial stability?' (28 December 2020), srb.europa.eu/en/node/1109.

[19] Andrea Enria, 'Hearing at the European Parliament's Economic and Monetary Affairs Committee' (27 October 2020), bankingsupervision.europa.eu/press/speeches/date/2020/html/ssm.sp201027~d284d6d6c8.en.html.

[20] Enria (n 18).

question, for example.[21] And it still remains to be seen how the reintroduction of insolvency filing duties will impact both the real economy and the financial sector.[22] Weak profitability remains a sector-wide concern amid the combined pressures of negative rates on net interest income, sluggish progress in fee generation and limited progress on cost measures. Banks' ability to lend to the real economy may also be significantly hampered by a spike in loan-loss provisions following an anticipated increase in non-performing loans (NPLs).

Still, optimism is returning to the financial sector, not only in Europe but on a global scale.[23] Part of the explanation is certainly the frequently-cited point that in this crisis, different from 2008, banks are seen as part of the solution and not the problem. Thanks to the post-financial crisis regulatory agenda, the banking sector is more robust today than it was in 2008. Banks have built up significantly more solid capital and liquidity positions than in 2008 on the back of many policy and regulatory measures undertaken following the financial crisis.

But the most important lesson from the present crisis is that every crisis involves new opportunities.[24] One year down during the pandemic, these opportunities are now clearly visible, and it appears that the financial market may be at the

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[21] See, in this volume, 'Chapter 2: When and how to unwind COVID-support measures to the banking system?' by Rainer Haselmann & Tobias Tröger.
[22] Chris Bryant, 'We Can't Hold Off the Bankruptcy Wave Forever – A cataclysm may yet be avoided, but insolvencies won't stay this low' (*Bloomberg*, 5 May 2021), bloomberg.com/opinion/articles/2021-05-05/europe-can-t-hold-off-the-bankruptcy-wave-forever.
[23] See ECB, *Financial Stability Review* (May 2021), ecb.europa.eu/pub/financial-stability/fsr/html/ecb.fsr202105~757f727fe4.en. html.
[24] Nigel Moden, 'Why 2021 is an opportunity to transform European banking' (*EY Outlook*, 18 March 2021), ey.com/en_gl/financial-services-emeia/why-2021-is-an-opportunity-to-transform-european-banking.

forefront to embrace them. The COVID-19 crisis has accelerated the rapidly changing environment that financial firms are operating in, characterised by evolving and redefined customer needs, increasing competition, disruption from emerging startups and fintechs.

New value is increasingly being found at the intersection of *digital technologies* and *sustainability*. It is these two twin challenges that the financial sector will face over the next years, when the immediate COVID shock is subsiding.[25] These twin challenges are reflected in various policies that pursued around the globe. One example is the agenda that drives the implementation of the recovery plan 'Next Generation EU'. While the plan involves many different activities, two policy areas stand out: the lion share of the funds are earmarked for initiatives that are either sustainability-oriented, promote the digitalisation of European businesses, or combine the two.[26] Taken together, the EU and its Member States have dedicated roughly 20% of their combined stimulus spending to green projects, with a substantial focus on green technology, thereby significantly outpacing the corresponding US plan.[27]

European companies' early lead in sustainability could make them a natural to succeed in this transformation challenge. Research has shown that both companies and investors are

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[25] See Adrian TH Kuah and Roberto Dillon, *Digital Transformation in a Post-Covid World: Sustainable Innovation, Disruption, and Change* (CRC Press forthcoming 2022).
[26] See the overview at ec.europa.eu/info/strategy/recovery-plan-europe_en.
[27] Peter Brennan, 'US risks green tech leadership as Europe makes play with COVID-19 stimulus' (*S&P Market Intelligence*, 14 September 2020), spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/us-risks-green-tech-leadership-as-europe-makes-play-with-covid-19-stimulus-60164318.

becoming increasingly aware of the challenge to reconcile their approaches to both digitalisation and sustainability. For example, in 2020, 47% of the largest European firms discussed sustainability-related topics with their investors, which represents a significant increase in comparison to 27% in 2018.[28] At the same time, the European figure is 20 percentage points ahead of the North American peer group. Crucially, in 2020, 52% of these European companies also discussed technology-related topics in their earnings calls, on par with firm in North America and the Asia-Pacific region.[29] During the 2020 proxy season, votes on environmental concerns increased by nearly 25%.[30] Executives in financial firms see the movement toward responsible business and stakeholder capitalism as one of the trends likely to have the greatest impact on their companies.[31]

4. Towards a past-pandemic agenda of twin transformation

Paradigm shocks such as the ongoing COVID crisis necessitate swift adjustments to retain a market position. As the immediate crisis situation is easing, however, banks are actively working on new value propositions and business models for the future. Even though legacy institutions are sometimes slow to embrace change, it becomes clearly visible now that the pandemic has increased the need to move into both technological and

[28] Accenture, 'The European Double Up: A twin strategy that will strengthen competitiveness' (2021), accenture.com/acnmedia/PDF-144/Accenture-The-European-Double-Up.pdf.
[29] ibid.
[30] Moden (n 24).
[31] ibid.

sustainable solutions for financial services. This section reviews these twin prospects.

4.1. Asset mix

The major trend towards greater sustainability on financial markets has long been in the making, but was significantly accelerated during the pandemic. In many ways, the intellectual starting point for a substantial re-direction of the world economy towards greater sustainability orientation was the adoption of the UN Sustainable Development Goals (SDGs) back in 2015, an ambitious agenda to be implemented by 2030.[32] Reinforced by the ambitious Paris Agreement[33] on climate change mitigation, adaptation, and finance, signed in 2016, the recognition grew that activity on all levels is warranted to achieve these ambitious goals. These agendas were supported by the grassroots initiative ‘Fridays for Future’ that dominated the public discourse during 2018-19.[34] But it was the COVID-19 pandemic that caused a serious fundamental global rethink of our values and goals during 2020-21, that pushed sustainability to the top level.[35] Consensus has emerged that

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[32] UN General Assembly, *Resolution 70/1 adopted on 25 September 2015 – Transforming our world: the 2030 Agenda for Sustainable Development*, undocs.org/A/RES/70/1.

[33] The Paris Agreement was agreed between all member states of the United Nations Framework Convention on Climate Change (UNFCCC) on 12 December 2015 and entered into force on 4 November 2016. See unfccc.int/sites/default/files/english_paris_agreement.pdf.

[34] The first ‘school strike’ by Greta Thunberg was initiated in August 2018. See David Crouch, ‘The Swedish 15-year-old who's cutting class to fight the climate crisis’ (*The Guardian*, 1 September 2018), theguardian.com/science/2018/sep/01/swedish-15-year-old-cutting-class-to-fight-the-climate-crisis.

[35] JP Morgan, ‘Why COVID-19 Could Prove to Be a Major Turning Point for ESG Investing’ (1 July 2020), jpmorgan.com/insights/research/covid-19-esg-investing.

traditional policy tools (such as regulation, subsidies, and taxation) would be insufficient to reach the self-set goals. Policy makers world-wide have seized the idea and developed an array of activities, initiatives, and policy papers. For example, the 2018 Action Plan 'Financing Sustainable Growth' mandated EU agencies to report and advise on potential undue short-termism in financial markets.[36] The European Securities and Markets Authority (ESMA) reported back one year later and developed a number of proposals, including a revised disclosure framework for non-financial risk as well as reinforced monitoring of remuneration and engagement standards.[37]

On a different level, the European Central Bank has announced a pronounced a profound shift in its policies towards a sustainability-oriented programme. This will be relevant for the ECB on several fronts.[38] First, the ECB will take issues such as climate change into account in its economic analysis, including for example its macroeconomic models, forecasting methods, and risk assessments. Secondly, it will also be relevant for banking supervision, where it plans to engage with banks to raise awareness of risks emerging from climate change; the aim is to ensure that banks are able to manage these risks properly. Very importantly, then, climate change affects the ECB's monetary policy and asset purchase activity, where it

[36] EC, 'Action Plan: Financing Sustainable Growth' (Communication to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, 8 March 2018) COM(2018) 97 final, eur-lex .europa.eu /legal-content/EN/ TXT/PDF/?uri =CELEX:52018DC0097&from =EN.

[37] ESMA, *Report: Undue short-term pressure on corporations* (18 December 2019) ESMA30-22-762.

[38] See ECB, *Climate Change and the ECB*, ecb.europa.eu/ecb/climate/ html/index.en.html.

increasingly invests in green bonds, taking into account the need to avoid market distortions. And finally, it affects the perspective on financial stability, where experts measure and assess the risks posed to the financial system by climate change and communicate their findings to the public, to market participants and to policy makers.[39]

These efforts have been paralleled by increased engagement for ESG concerns through the international investor community. Most salient is the increased activism around ESG targets that is initiated by the 'Big Three' institutional investors, BlackRock, Vanguard, and StateStreet. These top three asset managers have significant power to influence corporate decisions: they control about 80 per cent of all global indexed money, making them a dominant force in the governance of public companies around the world.[40] Together, these three giants control a staggering 25 per cent of the shares of all S&P 500 companies, and this share is growing.[41] But green finance and the demand for impact investing is growing elsewhere, too.

This phenomenon is best explained by the new set of values that dominate the investment interests of the so-called 'millennial

[39] See on the ECB agenda Christine Lagarde, ECB President, 'Climate change and central banking' (Keynote speech at the ILF conference on Green Banking and Green Central Banking, Frankfurt am Main, 25 January 2021), ecb.europa.eu/press/key/date/2021/html/ecb.sp210125~f87e826ca5.en.html.
[40] John C. Coates IV, 'The Future of Corporate Governance Part I: The Problem of Twelve', corpgov.law.harvard.edu/wp-content/uploads/2019/11/John-Coates.pdf. See also David McLaughlin and Annie Massa, 'The Hidden Dangers of the Great Index Fund Takeover' (*Bloomberg Businessweek*, 9 January 2020), bloomberg.com/news/features/2020-01-09/the-hidden-dangers-of-the-great-index-fund-takeover.
[41] Lucian Bebchuk and Scott Hirst, 'Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy' (2019) 119 Columbia Law Review 2029, 2033.

generation', i.e., the cohort of the population born during the 1980s and 1990s reaching young adulthood in the early 21st century.[42] The millennial population is projected to peak in size and importance during the early 2030s.[43] This generation is currently entering its wealth accumulation phase. Over the next years, large amounts of wealth will pass from their 'Generation X' parents to this age group, estimated by one account to amount to $24 trillion.[44] Crucially, this new powerful generation markedly differs in its values from previous generations, or is at least perceived to do so. In a Deloitte survey, 63 per cent of millennials stated that they would understand the primary purpose of businesses as 'improving society' rather than 'generating profit.'[45] Out of the world's greatest challenges, most of them identified climate change and environmental issues as the greatest concern, still way above health care amidst the pandemic.[46] When it comes to investment preferences, millennials are also very different than their preceding generations. Generally speaking, millennials are less

[42] See William Strauss and Neil Howe, *Millennials Rising: The Next Great Generation* (Knopf Doubleday Publishing Group 2000).
[43] Richard Fry, 'Millennials Overtake Baby Boomers as America's Largest Generation', (*Pew Research Center*, 28 April 2020), pewresearch.org/fact-tank/2020/ 04/28/ millennials- overtake-baby-boomers -as- americas-largest-generation/.
[44] BlackRock CEO Larry Fink has called this trend 'the largest transfer of wealth in history'. See Larry Fink, '2019 Letter to CEOs: Purpose & Profit' (*BlackRock*, 2019), blackrock.com/corporate/investor-relations/2019-larry-fink-ceo-letter.
[45] ibid.
[46] Deloitte, 'The Deloitte Global Millennial Survey 2020' (2020) 9, deloitte.com/global/en/pages/about-deloitte/articles/millennialsurvey.html.

interested in investment returns and more interested in their investments reflecting their social values.[47]

As these preferences of business purpose are undergoing profound changes, it is understandable that the financial services sector must aim at offering products that the demand side seeks. It is in this light that many index funds are strengthening their efforts to redefine corporate valuations from an ESG perspective; and offering new financial instruments and index products that are focusing on different principles than just shareholder returns. What is more, a wave of ESG activism has led funds to use their voting power to promote ESG values – of course, also widely reporting about their efforts publicly with a view to catch the attention of the new wealthy investors.[48]

This is the place where the 'music is playing' for financial institutions in the years ahead. If they live up to this challenge, they can play a major role in addressing ESG concerns by further developing socially responsible products and services. They should see this as more than just a reputational imperative. Investors and customers are increasingly using ESG information to determine a business's value. Progress in ESG consistency frameworks such as the EU Taxonomy Regulation are likely to make a significant difference in facilitating such investments.[49] As the pandemic eases, there will likely be even more pressure to prioritise and disclose ESG factors. For instance, banks may step up efforts in providing innovative

[47] Michal Barzuza, Quinn Curtis and David Webber, 'Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance' (2020) 93 Southern California Law Review 1243, 1283 ff.
[48] Barzuza et al. (n 47) 1250.
[49] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 [2020] OJ L198/13.

finance and investment products and services through digital platforms to solve ESG issues and drive social value. This relates to the second major trend to which we now turn.

4.2. Digitalisation

The In recent months, the crisis has accelerated another important trend: it has changed the attitude and behaviour of financial services organisations, firms, and consumers towards the use of digital applications and platform models. Given that COVID-19 restrictions such as social distancing measures are set to continue in the medium to long term, people are likely to avoid physical visits to banks, underscoring the need for digital solutions. Customers who previously had an affinity for stationary banking have now come to know and appreciate banking without the branch and new, digital payment processes. A boom in online and contactless or payments and digital wallets, the expansion of digital channels as well as cloud services and a massive increase in the number of online banking users were the result. Financial firms are using new digital technologies to maintain and to expand their market position. From introducing online banking solutions to integrated applications for financial accounting or applying for a loan, banks have embraced several digital initiatives.

Early research has shown that the COVID-19 pandemic has provided a boost to the fintech sector.[50] Moreover, we are witnessing a significant increase in the use of online platforms, such as e-commerce platforms and marketplaces.[51] The global

[50] Daniel Tut, 'FinTech and the Covid-19 Pandemic: Evidence from Electronic Payment Systems' (July 2020), MPRA Working Paper No 107077.
[51] PR Newswire, 'E-commerce Global Market Report 2020-30: COVID-19 Implications and Growth' (May 2020), researchandmarkets.com/reports/5023178/e-commerce-global-market-report-2020-30-covid-19.

ecommerce market is expected to grow from USD 1,808.5 billion in 2019 to USD 2,405.3 billion in 2020.[52] Social media platforms are also being used more intensively – 66% of social media consumers believe that staying home during the lockdown will increase their social media consumption.[53] The proliferation of remote working will also be a major step towards a truly global labour market. Firms are holding virtual shareholder meetings instead of physical ones.

It is generally acknowledged that these developments are set to continue irreversibly. The trend towards more online and mobile banking is likely to continue even after the pandemic has subsided. This largely cancels out the last regular point of contact between bank and customer – the supply of cash – across the board and across all age groups. Established market players are now in immediate competition with direct and neo-banks, which can produce the same products in a leaner fashion and in high quality by using digital processes and modern IT. At the same time, the IT environments of many traditional institutions are approaching the end of their lifecycle and will have to be replaced in the foreseeable future. There is a growing need to develop digital skills across the workforce.

Nevertheless, promising opportunities are opening up right now for many incumbent institutions. At the peak of the pandemic,

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[52] PR Newswire, 'Impact of COVID-19 on Worldwide e-commerce Markets, 2020-2030 – Revenue Projections, Trends and Developments Arising from the Pandemic' (June 2020), prnewswire.com/news-releases/impact-of-covid-19-on-worldwide-e-commerce-markets-2020-2030---revenue-projections-trends-and-developments-arising-from-the-pandemic-301080251.html.

[53] Globe Newswire, '66% of Social Media Consumers Expect Their Social Media Consumption to Increase During Coronavirus Confinement' (March 2020), globenewswire.com/ news-release/ 2020/03/18/ 2002921/ 0/en /66-of-Social –Media -Consumers- Expect-Their -Social-Media- Consumption-to-Increase-During -Coronavirus -Confinement.html.

the established institutions played an important role in their customers' financial stability. For example, they were instrumental in ensuring lending to the real economy, and they were the main conduit for paying out major government support programmes during the crisis. Traditional institutions will benefit from this trust to gain ground in the competitive environment.

Due to the changes brought in by the COVID outbreak, the platform economy will make further progress. Creating supply and demand between different parties via digital platforms is fundamental, through which companies, financial services providers, and individuals are linked by value creation. This creates an ecosystem in which both products and services, as well as knowledge and skills are exchanged.

With a platform economy in place, financial institutions could think of digital platforms like Upwork, Uber, or Airbnb, to provide products and services that drive value creation through establishing new self-employment avenues and improving the environment by sharing assets. The power of platforms for financial services is no more clearly in sight than in China, where large corporate groups use the power of platforms to offer a broad range of services under one roof. Anyone wanting to see what is possible in the platform economy should turn their attention to China. Hardly any of the major players are more advanced than Tencent and Alibaba, who merge functional offerings, social content and adjacent financial services. Ant Group is a part of the Alibaba empire and operates AliPay, a third-party mobile and online payment platform which handles the related actual payment on the platform. Consumers can draw the payment money from Ant's affiliate Yu'e Bao, one of the world's largest money-market fund, which is part of the same smartphone app.[54] Among other services, Ant also houses Sesame Credit, a private credit scoring and credit rating system, which uses data from Alibaba's services to compile its score.

These examples may not be immediately forthcoming in Europe and are most likely not compatible with EU data protection law. But still they represent one version of the future which more than clearly suggests where the journey is headed.

5. Mastering and linking the twin challenges

Value creation through digital tools or on the platform economy is not only limited to monetary value for businesses or added value for customers, but can also concern a social value for society, for example, for the purpose of sustainability. In fact, the real challenge will be to *combine* both twin challenges and to learn from them for the future orientation of the financial services framework.[55]

Most European firms are in a good position to pursue a twin transformation. Some commentators argue that Europe has a technological advantage in such 'green technology', and that the green movement will be a winner from the present crisis.[56] European companies often outperform their peers in sustainability rankings or on ESG ratings. They are, however,

[54] John Detrixhe, 'China no longer runs the world's largest money market fund' (*Yahoo! Finance*, 28 January 2020), finance.yahoo.com/news/china-no-longer-runs-world-130356458.html.

[55] Adrian T. H. Kuah and Roberto Dillon (eds), *Digital Transformation in a Post-Covid World: Sustainable Innovation, Disruption, and Change* (Routledge 2022).

[56] Neil Richardson, Investment Director at Aberdeen Standard, 'US risks green tech leadership as Europe makes play with COVID-19 stimulus' (*S&P Global Market Intelligence*, 14 September 2020), spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/us-risks-green-tech-leadership-as-europe-makes-play-with-covid-19-stimulus-60164318.

trailing others in the adoption of technology-oriented solutions.[57]

Shining examples abound. New fintech applications offer the potential to unlock green finance technologies: for example, they may create blockchain applications for sustainable development; blockchain use-cases for renewable energy and climate finance; and innovation in financial instruments, including green bonds.[58] In another context, the platform economy, as discussed above, may add a powerful element linking both sustainability and digitalisation. For example, 'Ant Forest' is a product of the above-mentioned Ant Group that encourages users to record their low-carbon footprint through daily actions, such as taking public transportation or paying utility bills online rather than on paper. For each such action, they receive 'green energy' points with which they can exchange for real trees that Ant plants. And even the frequently criticised cryptocurrencies may ultimately no longer be considered as 'dirty' as Elon Musk argues that there are 'green solutions' for bitcoin miners.[59]

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[57] Accenture, 'The European Double Up: A Twin Strategy that will Strengthen Competitiveness' (2021), accenture.com/acnmedia/PDF-144/Accenture-The-European-Double-Up.pdf.

[58] Darius Nassiry, 'The Role of Fintech in Unlocking Green Finance', in Jeffrey D. Sachs, Wing Thye Woo, Naoyuki Yoshino, Farhad Taghizadeh-Hesary, *Handbook of Green Finance* (Springer 2019).

[59] Joe Sommerlad, 'Bitcoin mining: How Elon Musk's "potentially promising" solution to climate woes could already exist', (*The Independent,* 25 May 2021), independent.co.uk/climate-change/bitcoin-mining-elon-musk-climate-b1853445.html.

6. Conclusion

The pandemic was and is in many ways an extraordinary crisis for mankind. The immediate reactions by regulators and legislatures around the globe in the field of financial stability were strongly motivated by the fear of a fresh financial and economic crisis. Regulators proved determined to rescue and stabilize the financial sector and thus support the continuation of large parts of the real economy.

Fortunately, legal obstacles proved surmountable. Crisis response in the eye of an existential threat necessarily must be drastic and cannot be upheld by legalistic obstacles. Just like in other epochal crises, I maintained, legalistic objections to economic necessities are neither warranted nor desirable.

As the immediate emergency lies behind us, the financial sector begins to understand some aspects of the pandemic crisis as an opportunity. Panic has given way to a more considerate, long-term vision on how to best cope and live with the pandemic; and more importantly still, it has been replaced with considerations on how to return to normal and improve the financial market for the future after the pandemic is over.

Two main trends emerge, both of which were already in the making before the onset of the crisis: the twin challenges of promoting both sustainability and digitalisation. The European financial sector is well placed to embrace both of these challenges, and to understand them as opportunities. Firms as well as regulators should provide the framework to combine both challenges towards green technology. Legal, organisational, and economic hurdles remain, and will have to be mastered.

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4. EU financial regulation in times of instability

Danny Busch

* * *

1. Introduction

We live in times of great uncertainty and change. Naturally, this is true worldwide and not just of our old, trusted Europe. The major themes of our time are playing a defining role in financial law as well: the coronavirus crisis, sustainability, the onward march of technology, the unceasing struggle between integration and federalism on the one hand and protectionism and nationalism on the other (think, for example, of Brexit and nationalist tendencies in countries such as Poland and Hungary) and, last but not least, the pressure exerted by major geopolitical powers such as China, the United States and Russia. These themes have largely shaped financial law in Europe in the recent past and look set to do so in the future as well. So, let’s get started as we have a lot to discuss.

2. Capital Markets Union Action Plan

2.1 General

Although we may live in uncertain times, this has by no means dampened the European Commission's regulatory zeal, at least not in relation to the financial sector. Take the Capital Markets Union (CMU) Action Plan which the Commission launched in September 2015.[1] The idea of the plan is simple, namely to ensure that those needing and providing capital can find each other more easily within Europe, especially across borders. This could occur through the intermediary of a bank, the capital markets, or alternative channels such as crowdfunding. In addition, it is thought that more non-bank funding will reduce dependence on the traditional banking sector and make for better absorption of economic shocks.[2]

The European Commission plans to achieve the CMU mainly by removing barriers and introducing rules to facilitate investment, and perhaps also by means of a European grant here and there. This was so when the CMU Action Plan was launched in 2015, and it was still the case shortly after the Brexit referendum on 23 June 2016.[3] The CMU Action Plan 2020, which the Commission launched in September 2020 in the

[1] See EC, 'Action Plan on Building a Capital Markets Union' (Communication, 30 September 2015) COM(2015) 468 final.
[2] EC, 'Capital Markets Union – Accelerating Reform' (Communication, 14 September 2016) COM(2016) 601 final, 2.
[3] Since the Brexit referendum, however, the CMU agenda has been slightly modified, with more emphasis on supervisory convergence (no integrated financial markets without supervisory convergence or even a central supervisor) and a genuine new addition to the CMU family: the Sustainable Finance Action Plan. For more information on these aspects, see sections 2.6 and 3 below.

midst of the coronavirus chaos, is based on the same thinking.[4] Assuming that we believe that the CMU can be brought about through EU legislation, this must of course be the right approach. But this is no easy task for the financial sector in particular, partly because the financial markets are so dynamic and therefore in a state of constant flux.

Moreover, as Europe is not a federation but, for the most part, a motley collection of sovereign states, all kinds of national and hence potentially obstructive rules continue to exist. Obvious examples are in the fields of tax law, contract law, property law, insolvency law and company law – all of which are still essentially national in nature. To tackle these problems, the Commission's CMU Action Plan 2020 makes bold proposals in two of these fields.

2.2 Standardised EU-wide system for withholding tax relief procedures

First, in the field of taxation. Taxes can be a barrier to cross-border investment. According to the Commission, alleviating the tax-associated burden in cross-border investment does not necessarily require harmonisation of tax codes or rates. A significant burden ascribed to taxation is caused by divergent, burdensome, lengthy, and fraud-prone refund procedures for tax withheld in cases of cross-border investment. These procedures

[4] EC, 'A Capital Markets Union for People and Business – New Action Plan' (hereinafter: the 'CMU Action Plan') (Communication, 24 September 2020) COM/2020/590 final. As regards the Final Report of the High-Level Forum on the EU Capital Market Union, which preceded the Commission's most recent CMU proposals, see, for example, Katja Langenbucher, 'Building a Capital Market – the Final Report of the High Level Forum of the EU Capital Market Union' (2020) 17 European Company and Financial Law Review 601.

cause considerable costs that dissuade cross-border investment where taxes on the return on investment need to be paid in both the member state of the investment and that of the investor and can be reimbursed only after a lengthy and costly process. These considerations result in Action 10 of the CMU Action Plan 2020: in order to lower costs for cross-border investors and prevent tax fraud, the Commission promises to propose a common, standardised, EU-wide system for withholding tax relief at source.[5]

2.3 Harmonisation – or in any event increased convergence – of non-bank insolvency law

Second, the Commission makes a proposal in its CMU Action Plan 2020 concerning non-bank insolvency law. The Commission notes that the stark divergence between national insolvency regimes is a long-standing structural barrier to cross-border investment. Divergent and sometimes inefficient national regimes make it difficult for cross-border investors to anticipate the length and outcome of value recovery proceedings in bankruptcy cases, rendering it difficult to adequately price the risks, particularly for debt instruments. Harmonisation of certain targeted areas of national insolvency rules or their convergence could enhance legal certainty. Furthermore, regular monitoring of the efficiency of national insolvency regimes would allow member states to benchmark their insolvency regimes against those in other member states. This might encourage those member states with underperforming regimes to reform them. The results of the monitoring could also feed into the European Semester process. These considerations result in Action 11 of the CMU Action

[5] EC (n 4) 12.

Plan 2020: to make the outcomes of insolvency proceedings more predictable, the Commission will take a legislative or non-legislative initiative for minimum harmonisation or increased convergence in targeted areas of non-bank insolvency law. In addition, together with the European Banking Authority (EBA), the Commission will explore possibilities to enhance data reporting in order to allow for a regular assessment of the effectiveness of national loan enforcement regimes.[6]

Actions 10 and 11 are certainly initiatives worth considering. But whether these plans will reach the finish line and, if so, in what form remains to be seen. EU intervention in national tax law and private law is and will remain a sensitive subject.

2.4 Simplification of public listings for SMEs

Aside from the fact that Europe is not a federation but basically a jumble of sovereign states, which is only too conducive to the continued existence of all kinds of national and thus potentially obstructive rules (see sections 2.1 to 2.3 above), the CMU project is largely a bottom-up project. In other words, the creation of an integrated European capital market is mainly up to those who provide and seek capital themselves. An important secondary objective of the CMU project is to improve the access of SMEs to funding. At present, SMEs in Europe are still mainly reliant on bank loans. If the banking sector is doing badly, this immediately affects SMEs. We were able to see this during the previous financial crisis. At the time, banks were extremely reluctant to provide credit to SMEs, with all the consequences

[6] EC (n 4) 12-13. See also EBA, *Report on the benchmarking of national loan enforcement frameworks – response to the European Commission's call for advice on benchmarking of national loan enforcement frameworks (including insolvency frameworks) from a bank creditor perspective* (18 November 2020) EBA/Rep/2020/29.

that entailed.[7] In the current coronavirus crisis, we are again seeing that banks are increasingly restricting the flow of funding for SMEs. So, from this point of view, it is a good idea for SMEs to be given better access to other sources of funding, making them less reliant on bank loans. Easier access for SMEs to the capital markets would therefore be a good thing. They can then attract financing by issuing marketable bonds and shares. Under MiFID II and the Prospectus Regulation, it is now possible to obtain a listing in the EU on a so-called 'SME growth market'.[8] This is less complicated and less expensive than a real stock exchange listing. But the SME growth market does not yet qualify as a resounding success. Given the complexity of the process it involves, resorting to the capital markets is evidently still an unattractive and unnatural route for SMEs. What is also questionable is whether there are capital providers who see a profit in such an investment.

In view of Action 2 of the CMU Action Plan 2020, the Commission too realises that more must be done to entice SMEs to the capital market. In order to promote and diversify small and innovative companies' access to funding, the Commission wishes to assess whether the listing rules for public markets can be further simplified. Unfortunately, how exactly the

[7] See, e.g., Gert Wehinger, 'SMEs and the credit crunch: Current financing difficulties, policy measures and a review of literature' (2014) OECD Journal: Financial Market Trends, Volume 2013/2, oecd.org/finance/SMEs-Credit-Crunch-Financing-Difficulties.pdf.

[8] Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Directive 2003/71/EC (the Prospectus Regulation) [2017] OJ L 168/12, Article 15; and Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (MiFID II / the Markets in Financial Instruments Directive II) [2014] OJ L 173/349, Article 33.

Commission envisages achieving this is not made clear in the CMU Action Plan 2020. Whatever the case, the Commission has also announced that it will continue its work on creating an SME IPO fund. The fund aims to make it easier for SMEs, particularly in sectors of strategic importance to the EU, to raise capital and finance their growth. As the coronavirus crisis has radically changed the economic landscape in the EU, it will be necessary to reaffirm the ambition to support the financing of smaller companies and innovative scale-ups. In the Commission's opinion, this makes the case for the urgent creation of an ambitious SME IPO fund even more compelling. It will also continue its work on supporting the development of local public markets, notably by looking into how stock market indices can support liquidity in SME equity.[9] But luring SMEs to the stock exchange will not be easy. And even if it does succeed, it remains to be seen whether investors will be willing to invest in SMEs of this kind. And that brings us to the next point.

2.5 European single access point (ESAP) for financial and sustainability-related company information

Reliable, standard information about SMEs and start-ups is essential not only for the purposes of a public listing but also to get investors to invest in such companies. But at present reliable, standard information is in very short supply, certainly about companies in other countries. It is against this background that Action 1 of the CMU Action Plan 2020 should be seen: the Commission undertakes to propose the setting-up of an EU-wide platform (European single access point / ESAP) to provide investors with seamless access to financial and sustainability-

[9] EC (n 4) 7-8.

related information on companies.[10] This is an excellent idea, but not so easy to achieve in the case of information about SMEs and start-ups. There is currently no EU-wide standard for information on companies of this kind. It must therefore first be developed, either by means of EU legislation or by means of soft law, for example drawn up by the SME and start-up community itself, or by a combination of the two.

2.6 Centralisation of supervision of the European financial markets

The CMU project may be largely a bottom-up project, but there are certainly also aspects that require a top-down approach. Harmonised rules are essential for a level playing field in Europe and will have to be set by the European legislator (top-down). Some progress has been made on this point in recent years, especially since many European rules have now been enacted as EU regulations.

But that's not all that needs to be done. The supervision of compliance with these European rules is still largely in the hands of national financial supervisors. Despite uniform European rules, Europe still has no level playing field and no truly integrated financial markets, but this is and remains the aim of the CMU project. Hence, convergence or even centralisation of supervision is fairly high on the CMU agenda of the European Commission. Unfortunately, progress on this subject is slow. As long ago as 2017 and 2018, for example, the Commission made an attempt to designate the European Securities and Markets Authority (ESMA) as the direct supervisor of certain types of investment institution and

[10] ibid 7. For the ESAP consultation document, see: ec.europa.eu/info/consultations/finance-2021-european-single-access-point_en.

crowdfunding service providers, and wanted to give it the power to approve certain categories of prospectuses.[11] Nevertheless, according to Action 16 of the CMU Action Plan 2020, the European Commission will consider proposing measures for stronger supervisory coordination or direct supervision by the European supervisory authorities.

Does this mean that nothing at all has been achieved in terms of centralising supervision of the European financial markets? No, some progress has been made. ESMA already directly supervises credit rating agencies (CRAs) and trade repositories (TRs).[12] A CRA publishes assessments of the creditworthiness of a company or government.[13] A TR is an entity that centrally collects and maintains the records of derivatives in a trade repository. TRs provide regulators and supervisors with more information about the derivatives market. From 1 January 2022, ESMA will also directly supervise data reporting service

[11] EC, *Regulation to amend the regulations on EU supervisory bodies on banking, insurance, and pension and markets and securities, and various regulations on financial instruments* (Proposal, 20 September 2017) COM(2017) 536 final; and EC, *Regulation on European Crowdfunding Service Providers (ECSP) for Business* (Proposal, 8 March 2018) COM(2018) 113 final.

[12] It has these powers under Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies (CRA Regulation) [2009] OJ L 302/1 (as subsequently amended); Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, (European Market Infrastructure Regulation or EMIR), [2012] OJ L 201/1 (as subsequently amended); and Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012 (Securities Financing Transactions Regulation or SFTR) [2015] OJ L 337/1.

[13] For a recent discussion of the liability of CRAs, see Dorine J. Verheij, *Credit Rating Agency Liability in Europe* (thesis at the University of Leiden) (Eleven Publishers 2021).

providers and administrators of key benchmarks.[14] While all of these may be encouraging steps forward, they are of course still rather meagre in their totality. At its core, the supervision of the European financial markets is still conducted at national level and this is in stark contrast to the lightning-fast establishment of the European Banking Union (EBU).

2.7 Consolidated tape

Since the entry into force of the MiFID I regime on 1 November 2007, there has been free competition in the EU/EEA between the established stock exchanges (known as 'regulated markets') and alternative trading platforms (known as 'multilateral trading facilities' and 'organised trading facilities'). All these 'markets' fulfil the same economic function, namely matching supply and demand for securities and other financial instruments on a multilateral basis. Competition between trading platforms is good, as it reduces the costs of executing client orders and thus benefits investors.[15]

[14] See Regulation (EU) 2019/2175 of the European Parliament and of the Council of 18 December 2019 [2019] OJ L 334/1, Articles 4 and 5 Regulation (EU) No 2175/2019 (which amend provisions of the Benchmark Regulation and the Markets in Financial Instruments Regulation (MiFIR)). See also Grundmann-van de Krol, 'ESMA als toezichthouder: enkele verschillen vergeleken met de AFM' (2020) Ondernemingsrecht 2020/112.

[15] The MiFID I regime consisted of the following instruments: Directive 2004/39/EC (MiFID); Directive 2006/73/EC (MiFID Implementing Directive); Regulation (EC) No 1287/2006 (MiFID Implementing Regulation). The MiFID II regime consists of the following instruments: Directive 2014/65/EU (MiFID II); Regulation (EU) No 600/2014 (the Markets in Financial Instruments Regulation / MiFIR); some forty implementing and delegated acts). For a list, see ec.europa.eu/info/law/markets-financial-instruments-mifid-ii-directive-2014-65-eu/amending-and-supplementary-acts/implementing-and-delegated-acts_en (under the heading: 'implementing and delegated acts: full list'). As regards regulated markets, multilateral trading facilities and organised trading

But it also has disadvantages. Owing to the sheer number of platforms that are active, the markets are to a greater or lesser extent fragmented. As a result, there may be insufficient liquidity per platform, resulting in sub-optimal pricing and price differences (albeit often minimal) between the platforms. How can we ensure that the prices on all these platforms continue to converge and that the various platforms together form a fully integrated market in economic terms? Many feel that the answer lies in greater transparency. However, there is not yet a provider that offers all these data to the market in consolidated form. Unlike in the United States, we in Europe do not yet have what is known as a consolidated tape provider.

Nonetheless, the position of consolidated tape provider has been explicitly regulated since the entry into force of MiFID II on 3 November 2018. Such a provider must have an authorisation and is subject to continuous supervision. Under MiFID II, the local supervisor is responsible for granting the authorisation and supervising the provision of the service, but, as noted earlier, these powers are to be transferred to ESMA as of 1 January 2022 (the consolidated tape provider is a species of the data reporting service provider genus, about which more has been

facilities, see: Floortje F. Nagelkerke, Chapter 21 – *Handelsplatformen* (Trading Platforms), in Danny Busch and C.W.M. (Kitty) Lieverse, *Handboek beleggingsondernemingen* (Investment Firms Handbook) (SOR vol. 112, Kluwer 2019) (below: 'Busch and Lieverse (2019)'); Danny Busch and J.E.C. (Han) Gulyás, Chapter 8 - *Alternative Trading Platforms in the EU: Multilateral Trading Facilities, Organised Trading Facilities and Systemic Internalizers*, in Jens-Hinrich Binder and Paolo Saguato (eds), *The Law and Regulation of Market Infrastructure* (OUP 2021) (to be published shortly) (below: 'Binder and Saguato (2021)'); as regards the best execution obligation, see Danny Busch, Chapter 17 – *Best execution*, in Busch and Lieverse (2019).

said above in section 2.6).[16] However, a consolidated tape provider is not guaranteed a monopoly and is also not completely free to determine the price it charges for the trade data. The next step could be to make it possible for the provider to have a monopoly, subject to certain conditions, by amending MiFID II. The most far-reaching solution would be for the EU itself to set up a consolidated tape provider, for example by entrusting ESMA with this responsibility.

Which of these routes the Commission intends to take is not really clear from the CMU Action Plan 2020. In Action 14, the Commission promises in any event to propose ‘the creation of an effective and comprehensive post-trade consolidated tape’, but only for ‘equity and equity-like financial instruments’ (i.e., not for marketable bonds and derivative products). The Commission considers that this, together with the European single access point (Action 1 discussed in section 2.5 above), would give investors access to much-improved information at a pan-European level.

On the subject of competition, Euronext and other established stock exchanges are not keen on the advent of a consolidated tape provider. After all, their business model is based to a large extent on the sale of data of this kind. Indeed, such sales reportedly account for no less than 20% of Euronext’s turnover.[17]

[16] As regards data reporting service providers, see: Jelle Dinant, ‘Chapter 3C – Aanbieders van datarapportagediensten’ (Data reporting service providers), in Busch and Lieverse (2019).

[17] Lennart Zandbergen, ‘Beursuitbaters fel gekant tegen central systeem voor transactiedata’ (Stock exchange operators fiercely opposed to central system for trade data) (*FD*, 7 December 2020) 27.

2.8 EU recovery prospectus

The prospectus (an information document for investors) is an essential part of the CMU. It offers companies access to the European capital markets. As part of the initial CMU plans from 2015, the Commission proposed to modernise the Prospectus Directive and replace it with a Prospectus Regulation that is directly applicable in the member states. And with success because the Prospectus Regulation has been in force since 21 July 2019. As a result, the rules for issuers seeking a stock exchange listing and/or wishing to offer securities to the investing public can be found in the directly applicable legislation.[18]

In response to the coronavirus crisis, the Commission published the so-called Capital Markets Recovery Package (CMRP) on 24 July 2020 (i.e., before the publication of the CMU Action Plan 2020 discussed above). One of the CMRP proposals (which has since been adopted) concerned the introduction of an EU

[18] See the Prospectus Regulation. For more information about the Prospectus Regulation, see: Tomas M. C. Arons, *Prospectus: plicht en aansprakelijkheid* (Prospectus: obligation and liability), Financieel Juridische Reeks vol. 18, (Paris 2020); Simone Alvaro, Raffaele Lener and Paola Lucantoni (eds), *The Prospectus Regulation – The long and winding road*, Quaderni giuridici 22 (ottobre 2020), consob.it/web/consob/novita/-/asset_publisher/xMXdfdeSuZFj/content/quaderno-giuridico-consob-n-22/11973; C. W. M. (Kitty) Lieverse, 'Chapter 10 – Effecten: het uitgeven en aanbieden daarvan, de prospectusplicht' (Securities: issuing and offering them and the prospectus obligation), in Danny Busch and C. W. M. (Kitty) Lieverse and Jan Willem P. M. van der Velden (eds), *Leerboek Financieel Recht* (Financial Law Manual) (Ars Aequi Libri 2021) (below: Busch, Lieverse and Van der Velden (2021)); Danny Busch, Guido Ferrarini and Jan Paul Franx (eds), *Prospectus Regulation and Prospectus Liability* (OUP 2020); see also 'Prospectus Regulation theme issue', Tijdschrift voor Financieel Recht 2019/7 and 8 (edited by D. Busch, W.J. Horsten and G.W. Kastelein), denhollander.info/Financieelrecht/uit gave/5-2019-6.

recovery prospectus.[19] The severe economic consequences of the pandemic call for a swift introduction of measures to facilitate investment in the real economy, allow a rapid recapitalisation of European companies, and enable issuers to access the capital markets at an early stage of the recovery. That is the *raison d'être* of the EU recovery prospectus. The idea is that this short-form prospectus is (i) easier to produce for issuers, (ii) easy to read for investors, and (iii) easy to scrutinise for national financial regulators (approval within 7 instead of 10 business days). The EU recovery prospectus consists of a single document of no more than 30 pages, which focuses on the essential information that investors need in order to make an informed decision. It is available only to issuers who wish to issue shares (i.e., not bonds) and have been listed on a regulated market (stock exchange) or an SME growth market for at least 18 months. As with 'regular' prospectuses, the EU recovery prospectus uses the 'EU passport mechanism', which means that all EU investors can finance these companies if they wish. 31 December 2022 is the last date on which it will be possible

[19] Regulation (EU) 2021/337 of the European Parliament and of the Council amending Regulation (EU) 2017/1129 as regards the EU Recovery prospectus and targeted adjustments for financial intermediaries and Directive 2004/109/EC as regards the use of the single electronic reporting format for annual financial reports, to support the recovery from the COVID-19 crisis, [2021] OJ L 68/1. Other proposals that are part of the Capital Markets Recovery Package concern amendments to MiFID II and to the securitisation rules as contained in the Securitisation Regulation and the Capital Requirements Regulation (CRR). See, EC, *Coronavirus response: How the Capital Markets Union can support Europe's recovery* (24 July 2020), ec.europa.eu/info/publications/200722-proposal-capital-markets-recovery_en. As regards the proposed adjustments to the securitisation rules, see section 7.4 (i) below. The MiFID II adjustments have already been adopted: Directive (EU) 2021/338. For more information about this 'MiFID II quick fix', see Rosemaijn E. Labeur, 'MiFID II gedragsregels en de pandemie: een Quick Fix' (2021) Tijdschrift voor Financieel Recht 2021/5.

to produce an EU recovery prospectus. While this is an excellent initiative in itself, it is relatively insignificant in the greater scheme of things. On the other hand, every little bit helps.

2.9 The Union and the Members States as providers and users of capital

Investors and especially the business community have been hit hard by the coronavirus crisis.[20] If investors already have capital available, they are likely to prefer investing in their own country rather than in another European country, whereas the very aim of the CMU is to encourage investors to invest more across borders. In times of uncertainty, people still choose the familiar, although this is probably less true of institutional investors such as large pension funds (e.g., the ABP Pension Fund).

But the Member States themselves can, of course, also act as providers and users of capital and thus provide a boost for the establishment of the CMU in these difficult times. As interest is at an historical low, they can borrow cheaply on the capital markets (in which capacity they therefore act as users of capital) and channel the money on to the business community in the form of loans, share capital or even gifts (in which capacity they are therefore providers of capital). Although the member states

[20] Paradoxically, the Amsterdam AEX Index reached its highest point ever during trading on 31 March (704.25 points) and the highest ever closing price on 1 April (708.43 points). Nowadays, this index is dominated by tech companies such as ASML and Adyen, which are precisely the businesses doing well during the coronavirus crisis. Naturally, the ultra-low interest rates are also playing a role. Cf. Marianne Slegers, 'AEX-index tikt hoogste punt ooit aan, middenin de coronacrisis' (AEX Index hits highest point ever, in the middle of the coronavirus crisis) (*FD*, 1 April 2021) 1 and 3; *Record slotstand van AEX sneuvelt na turbulent beursjaar* (Record closing position of AEX broken after turbulent stock market year) (*FD*, 2 April 2021) 5.

are bound by the EU rules on state aid, the European Commission is applying them relatively flexibly during the coronavirus crisis.[21] Moreover, the ECB and the euro area central banks are continuing for the time being to buy up government bonds on a massive scale via the secondary markets and have even upped the tempo somewhat recently.[22] Despite this huge buying programme, interest rates in the euro area are now rising somewhat, but that will not be allowed to spoil the fun for the time being.[23] Naturally, the situation in which national governments act as providers and users of capital has long been a reality, given the massive support they are providing to trade and industry in their countries. After all, this support is being financed by the issue of government bonds,

[21] See Articles 107-109 TFEU. For more information about state aid during the coronavirus crisis, see the EC's website at ec.europa.eu/competition/state_aid/what_is_new/covid_19.html.

[22] The CJEU confirmed in its judgments of 16 June 2015, case C-62/14 Case C-62/14 *Peter Gauweiler and Others v Deutscher Bundestag* [2015], and 11 December 2018, case C-493/17 *Heinrich Weiss and Others* [2018] that the ECB's programmes for the purchase of government bonds are permitted in principle. However, the German Constitutional Court (*Bundesverfassungsgericht*) recently took a very different view, resulting in a European row: BVerfG, Urteil des Zweiten Senats vom 05. Mai BVG2020 BV. For more about this, see Stefaan van den Bogaert and Vestert Borger, 'Hoog spel in Karlsruhe: Het Duitse Constitutionele Hot over het Public Sector Purchase Programme van de ECB' (2020) 95(39) Nederlands Juristenblad 2978-2989; Victor P.G. de Serière, 'Enkele opmerkingen over EU crisismaatregelen' (2020) *Ondernemingsrecht* 2020/IX; Victor P.G. de Serière, 'Het Bundesverfassungsgericht en de Europese Banken Unie' (2019) *Ondernemingsrecht* 2019/172; Christiaan W.A. Timmermans, 'Wie handelt er ultra vires?: Bundesverfassungsgericht vs EU Hof van Justitie' (2020) Nederlands Juristenblad 1791-1795; Danny Busch, 'Wat doet de Europese Unie ter bezwering van de coronacrisis?' (2020) Nederlands Juristenblad 1444-1455, at 1445-1447 and 1451-1452.

[23] See *Rentes stijgen door, ondanks opkopen in het ECB-programma* (Interest rates continue rising despite buy-ups in the ECB programme) (*FD*, 13 March 2021) 47.

which are then bought by the commercial banks and resold to the ECB and the national central banks. The EU itself can also act as a provider and user of capital. Indeed, this is already happening (see section 3.5 below).

Naturally, it is good and necessary in the short term for the EU and the member states themselves to act as capital providers to support national and European businesses. However, it will mainly be up to private sector organisations themselves to act as users and providers of capital in the medium and long term. Member states and the EU cannot provide capital indefinitely to the corporate sector since the burden of this lending will fall on future generations, just as the ECB and the national central banks cannot buy government bonds indefinitely, especially if inflation continues to rise. The establishment of the CMU is and remains a long-term project that can succeed only through a combination of public and private measures at various levels.

3. Sustainable Finance Action Plan

3.1 General

The European Commission has pointed out that we are increasingly confronted by the consequences of climate change and resource depletion. It therefore wants more investment in 'green' companies and products. In its initial Sustainable Finance Action Plan (SFAP) of March 2018, the Commission states that as the financial sector acts as an intermediary between users and providers of capital, it has a key role to play in this green transition.[24] The SFAP is an integral part of the CMU Action Plan (see section 2 above) and must also be seen

[24] EC, 'Action Plan: Financing Sustainable Growth' (Communication, 8 March 2018), COM(2018) 97 final, 1.

in conjunction with the broader European climate plans (the Green Deal and the European Climate Law that forms part of it).[25]

The SFAP has the following aims: (i) reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth; (ii) manage financial risks stemming from climate change, resource depletion, environmental degradation and social issues; and (iii) foster transparency and long-termism in financial and economic activity.[26]

The action plan translates these aims into ten concrete measures: (1) establish an EU classification system (taxonomy) for sustainable activities; (2) create standards and labels for green financial products; (3) foster investments in sustainable projects; (4) incorporate sustainability when providing financial advice; (5) develop sustainability benchmarks; (6) better integrate sustainability in credit ratings[27] and market research; (7) clarify the duties of institutional investors and asset managers; (8) incorporate sustainability in prudential requirements for financial institutions such as banks and insurers (e.g. a lower capital adequacy requirement for loans to sustainable companies); (9) strengthen sustainability disclosure,

[25] See the Green Deal presented by the Commission on 10 December 2019 (COM(2019) 640 final) and the proposal forming part of it and dated 4 March 2020 for a European Climate Law (COM(2020) 80 final). For an amended and more ambitious proposal for a European Climate Law, see EC, *Regulation on establishing the framework for achieving climate neutrality and amending Regulation (EU) 2018/1999* (Proposal, 17 September 2020), COM(2020) 563 final (European Climate Law). See also EC, 'Stepping up Europes's 2030 climate ambition – Investing in a climate-neutral future for the benefit of our people' (Communication, 17 September 2020), COM(2020) 562 final.

[26] EC (n 24), 3.

[27] As regards credit ratings, see also section 2.6 above.

both for investors and for financial supervisors, for example through better integration of sustainability in accounting rule-making; (10) foster sustainable corporate governance and attenuate short-termism in capital markets.[28] In this chapter, I will focus on a few of the measures on which some progress has recently been made.

3.2 Taxonomy Regulation

When is a product or business 'green'? That is something we must agree on first. After all, if we in Europe do not have a shared understanding of what is ecologically sustainable, how

[28] EC (n 24) 4-11. For more about the SFAP or parts of it, see: Danny Busch, Guido Ferrarini and Anthony van den Hurk, 'Chapter 2 - The European Commission's Sustainable Finance Action Plan and other International Initiatives', in Danny Busch, Guido Ferrarini and Seraina Grünewald (eds), *Sustainable Finance in Europe – Corporate Governance, Financial Stability and Financial Markets* (EBI Studies in Banking and Capital Markets Law Vol. 1, Palgrave Macmillan 2021) (below: Busch, Ferrarini and Grünewald (2021)) (to be published shortly); Bart Bierens, 'Chapter 6 – De bancaire zorgplicht, klimaatverandering en het Europese 'Actieplan: duurzame groei financieren' (The banks' duty of care, climate change and the European Sustainable Finance Action Plan), in Danny Busch et al. (ed.), *Zorgplicht in de financiële sector* (SOR vol. 122, WoltersKluwer 2020); Volkan Capkurt and Gerard W. Kastelein, 'Op weg naar een Europese norm voor groene obligaties voor verduurzaming van de financiële sector' (2019) Tijdschrift voor Financieel Recht 2019/10 (about green bonds). For a broader look at sustainable financing, see R. van den Bosch and W. A. Brouwer, 'Klimaat & Duurzaamheid, uitdagingen en dilemma's voor banken – De invloed van duurzaamheid op de handelwijze van banken en financiële instellingen' (2021) 6 Nederlands Juristenblad 426-433; see also 'the Sustainability theme issue', Tijdschrift voor Financieel Recht 2020/10 (edited by M. Haentjens, A.J.A.D. van den Hurk and R.K. Pijpers); Victor P.G. de Serière, 'Toekomstmuziek of utopie: kan de overheid voorschrijven dat de financiële sector meer substantieel bijdraagt aan het breiken van klimaatdoelstellingen? Een overzicht' (2020) Ondernemingsrecht 2020/12; Frits-Joost Beekhoven van den Boezem, Corjo Jansen and Ben Schuijling (eds), *Sustainability and Financial Markets (*Law of Business and Finance Vol. 17, Kluwer 2019).

can we expect to arrange for the supply and demand of green capital to be better matched in Europe? In such a situation, there is the ever-present danger of confusion about terms and even plain deception because activities are presented as greener than they actually are (‘greenwashing’). So, it is a good thing that the Commission has decided to give top priority to establishing an EU classification system - or taxonomy - for sustainable activities (Action 1). Nor has Brussels wasted any time, because the Taxonomy Regulation had already been adopted by 18 June 2020.[29]

The Taxonomy Regulation contains uniform criteria for determining whether an economic activity qualifies as environmentally sustainable. The Regulation identifies six environmental objectives: (a) climate change mitigation; (b) climate change adaptation; (c) the sustainable use and protection of water and marine resources; (d) the transition to a circular economy; (e) pollution prevention and control; (f) the protection and restoration of biodiversity and ecosystems.[30] An activity qualifies as environmentally sustainable where it contributes substantially to one or more of the environmental objectives and does not significantly harm any of the other environmental objectives.[31]

But that’s not sufficient in itself. Based on technical advice from experts, the Commission is currently in the process of drawing up further rules (Level 2 legislation) which identify the actual activities that can be classified as sustainable. This concerns six

[29] Regulation (EU) 2020/852 of the European Parliament and of the Council on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 (hereinafter the Taxonomy Regulation) [2020] OJ L 198/13.
[30] Taxonomy Regulation, Article 9.
[31] Taxonomy Regulation, Article 3.

series of sustainable activities, each series corresponding to one of the six environmental objectives mentioned above. The first two series were submitted to the public for consultation in November 2020 and corresponded to the environmental objectives referred to at (a) and (b) above.[32] The Taxonomy Regulation will come into effect in phases: the first two environmental objectives on 1 January 2022 and the other four on 1 January 2023.[33] The further rules are bound to be a source of friction. It is apparent from a leaked proposal that the European Commission is considering classifying state-of-the-art natural gas power stations as green undertakings to make the funding of new power plants more attractive, much to the astonishment of scientists and environmental organisations.[34] And what about nuclear energy? A nuclear power plant may not emit greenhouse gases, but it does produce nuclear waste.[35]

3.3 Sustainable Finance Disclosure Regulation (SFDR)

An important step will be determining what activities are environmentally sustainable (see section 3.2 above). Once this has been accomplished, the next step will be to arrange for

[32] The draft regulation and two accompanying draft annexes can be downloaded at: ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en.
[33] Taxonomy Regulation, Article 27(2). See also: Christos V. Gortsos, 'Chapter 11 - The Taxonomy Regulation: more important than just as an element of the Capital Markets Union' in Busch, Ferrarini and Grünewald (2021).
[34] For more on this, see: 'Uitgelekt plan: Brussel wil moderne aardgascentrales milieuvriendelijk label geven' (*NOS*, 24 March 2021), nos.nl/artikel/2373904-uitgelekt-plan-brussel-wil-moderne-ardgascentrales-milieuvriendelijk-label-geven.html.
[35] Cf. Matthijs Schiffers, 'Kernenergie is de hete aardappel die de Commissie liever nog even doorschuift' (Nuclear energy is a hot potato the Commission doesn't wish to burn its fingers on just yet) (*FD*, 3 April 2021) 33.

financial intermediaries (such as asset managers and advisers) to integrate sustainability considerations into their investment policy and advice, and to provide transparency to the investing public about the extent to which they do this (Actions 7 and 9). Many financial intermediaries already did this to a greater or lesser extent because there has been considerable demand for sustainable investments for some time. However, until recently, they did not do so on the basis of harmonised rules at European level. This was changed by the new Sustainable Finance Disclosure Regulation (SFDR) on 10 March 2021, when most of its rules became applicable.[36] Incidentally, the term sustainability has a broader meaning in the SFDR than in the Taxonomy Regulation. Under the SFDR, a sustainable investment covers all three 'ESG' categories (i.e., environmental, social, and good governance objectives), whereas the Taxonomy Regulation relates only to environmental sustainability (i.e., the 'E' factor).[37]

Whatever the case, the SFDR is an important step forward as harmonised sustainability transparency is a dire necessity, basically because the alternative is not workable. After all, divergent national rules and market practices (i) make it very difficult to compare different financial products, (ii) create an uneven playing field for such products and for distribution channels, and (iii) erect additional barriers within the internal market. This in turn leads to confusion for investors and is, at worst, plain misleading because financial intermediaries promote their investments as sustainable when in reality they

[36] Regulation (EU) 2019/2088 of the European Parliament and of the Council on sustainability-related disclosures in the financial services sector (hereinafter: SFDR) [2019] OJ L 317/1, as later amended by the Taxonomy Regulation.
[37] SFDR, Article 2(17); and Taxonomy Regulation, Article 3.

are not (or much less so) (greenwashing).[38] The SFDR requires financial intermediaries to provide sustainability transparency on their website, in periodic reports, in promotional material and in pre-contractual information (at both entity level and product level).

But once again, this is not sufficient in itself. Most of the SFDR rules still have to be implemented at a practical level (Level 2 rules). The three European Supervisory Authorities (ESAs) take the lead in drafting these rules, but it is the Commission that adopts them and thus has the final say.[39] Although the coronavirus crisis delayed the drafting work at the ESAs, this was remarkably not seen by the European Commission as a reason for recommending that the SFDR itself become applicable at a later date. It was not until 4 February that the ESAs published their final drafts for the Level 2 rules.[40] The Commission was no longer able to adopt these rules before the SFDR became applicable on 10 March 2021. As an emergency measure, the joint ESAs therefore suggested to the national supervisors on 25 February that they encourage financial intermediaries to comply with the Level 2 rules anyway.[41] To add to the confusion, the three ESAs published a consultation document on 15 March 2021 which again provided for a change to what were termed the 'final' drafts of the Level 2 rules

[38] Cf. SFDR, recital (9).
[39] The three ESAs are: ESMA, EBA and EIOPA.
[40] ESAs, *Joint ESAs Final Report on RTS under SFDR* (2 February 2021), JC 2021 03.
[41] See ESAs, *Joint ESA Supervisory Statement on the application of Sustainable Finance Disclosure Regulation* (25 February 2021), JC 2021 06, esma.europa.eu/sites/default/files/library/jc_2021_06_joint_esas_supervisory_statement_-_sfdr.pdf.

published on 4 February.[42] This procedure certainly did not win any prizes for planning, because financial intermediaries hardly had any time to prepare.[43]

3.4 *Reliable sustainability-related company information*

And, on reflection, how do financial intermediaries actually get reliable sustainability-related information about the companies in which they invest? The companies themselves will often not have that information available at this early stage. I would like to remind the reader here of Action 1 of the CMU Action Plan 2020: the Commission undertakes to propose the setting-up of an EU-wide platform (European single access point / ESAP) to provide investors with seamless access to financial and sustainability-related information on companies (see section 2.5 above).

Whatever the case, financial intermediaries are dependent for the time being on third parties who claim to have access to this

[42] ESAs, *Joint Consultation on Taxonomy-related sustainability disclosures* (17 March 2021), JC 2021 22, 57 ff (for a consolidated version of the Level 2 rules), esma.europa.eu/system/files_force/library/jc_2021_22_-_joint_consultation_paper_on_taxonomy-related_sustainability_disclosures.pdf?download=1.

[43] It is evident from a letter dated 7 January 2021 from the ESAs to the European Commission (JC 2021 02) that financial intermediaries have a host of questions about the meaning of all kinds of terms used in the SFDR. For more about the SFDR, see Danny Busch, 'Chapter 12 - Sustainability Disclosure in the EU Financial Sector' in Busch, Ferrarini and Grünewald (2021) (for general information); Bastiaan T. B. Siemers, 'Informatieverschaffing over duurzaamheid door beleggingsinstellingen' (Provision of information about sustainability by investment institutions), Tijdschrift voor Financieel Recht 2021/1 and 2 (specifically in relation to investment institutions). See also the 'sustainability letters' from the AFM to the sector of 6 July and 16 December 2020 at afm.nl/nl-nl/nieuws/2020/juli/duurzaamheidsbrief-aan-sector;afm.nl/nl-nl/nieuws/2020/december/pensienuitvoerders-voorbereiden-sfdr-verordening.

sustainability-related information. But that immediately raises a further question: how can financial intermediaries be sure that these data are reliable? According to the Dutch Authority for the Financial Markets (AFM), its French counterpart *Autorité des Marchés Financiers (AMF)* and more recently, ESMA as well, providers of sustainability-related information must be regulated under an EU regulation and be subject to direct supervision by ESMA, just as is already the case with credit rating agencies (CRAs) under the CRA Regulation.[44]

3.5 Sustainable finance and the coronavirus crisis

As already noted, investors and especially the business community have been hit hard by the coronavirus crisis.[45] As less capital is available due to the current crisis (see section 2.10), it follows that less capital is also available for making the transition to a greener society. Implementation of the climate plans is likely to be delayed by the crisis. This is particularly tragic since there may be a link between climate change and the outbreak of pandemics.[46] So a delay in the realisation of the climate plans is actually not acceptable.

[44] See AFM & AMF, *Position Paper: Call for a European Regulation for the provision of ESG data, ratings, and related services* (15 December 2020) afm.nl/en/nieuws/2020/december/reguleer-aanbieders-duurzaamheidsdata. On this subject, see: Daniel Cash, 'Calls for ESG Rating Agency Regulation Grows Louder in Europe, But Could It Actually Save the Industry? (*CRRI*, 18 December 2020) creditratingresearchinitiative.blogspot.com/2020/12/calls-for-esg-rating-age ncy-regulation.html; ESMA, *Letter to EC on ESG ratings* (28 January 2021) ESMA30-379-423, esma.europa.eu/sites/default/files/library/esma30-379-423_esma_letter_to_ec_on_esg_ratings.pdf.

[45] But see above at n 20.

[46] That link was identified, for example, by the European Commission in the *Consultation on the renewed sustainable finance strategy* (8 April 2020) 3, ec.europa.eu/info/consultations/finance-2020-sustainable-finance-strategy_a nd.

However, three more positive notes may perhaps be struck. First, the coronavirus crisis may help us to realise that a video link, despite all its limitations, works quite well, and that it is not really necessary to fly around the world for face-to-face meetings. And second, the massive state aid provided by governments to their corporate sector gives them the opportunity to impose stringent green conditions, at least in theory. And, last but not least, the EU and its member states can themselves act as providers and users of green or social financing.[47]

Consider, for example, the funding of the EU programme for short-time working and part-time unemployment benefits (Support to mitigate Unemployment Risks in an Emergency, or SURE). SURE is being funded by raising a total of EUR 100 billion from the investing public through social bonds issued by the EU itself, which is an absolute first. The European Commission had already raised EUR 53.5 billion through the issuance of social bonds in four rounds under the EU SURE instrument in the period from 20 October 2020 to 26 January 2021. The issues consisted of 5, 10 and 15-year bonds. The great interest showed by investors translated into favourable bond price conditions for the EU. The funds raised were then funnelled to the member states in the form of loans to help them directly cover the costs associated with financing national short-time working schemes and similar measures in response to the

[47] It is also worth noting in this connection that the Bank of England has recently indicated that it is going to ensure that its own financing programmes are based on green principles. See Camilla Hodgson, Valentina Romei and Nathalie Thomas, 'Bank of England given new mandate to buy 'green' bonds' (*Financial Times*, 3 March 2021), ft.com/content/f436d69b-2bf0-48cd-bb34-644856fba17f. The UK therefore seems to be well ahead of the European central banks.

pandemic. On 27 October 2020, the EU SURE social bond was listed on the Luxembourg Green Exchange, a leading platform exclusively dedicated to sustainable securities.[48]

But there's more. During the Special European Council of 17-21 July 2020, the European heads of government did manage with great difficulty to reach an agreement on the European multiannual budget (2021-2027) and the Corona Recovery Fund. The European budget for 2021-2017 amounts to a total of EUR 1,074 billion. More money has been earmarked for innovation, sustainability, and climate action. 30% of all budget expenditure must contribute to the European climate target. In essence, the agreements about the Corona Recovery Fund (the so-called Next Generation EU plan) are as follows. There will be a fund of EUR 750 billion, which will be fully financed by the issuance of bonds by the EU itself. Of the amount thus raised, a sum of 390 billion euros is for grants, and the other 360 billion euros for loans. 30% of all expenditure of the Recovery Fund must contribute to achieving the European climate target.[49]

[48] See EC, *Report on the European instrument for Temporary Support to mitigate Unemployment Risks in an Ermergency (SURE) following the COVID-19 outbreak pursuant to Article 14 of Council Regulation (EU) 2020/672 SURE: Taking Stock After Six Months* (22 March 2021), COM(2021) 148 final, 9-11.

[49] See EC, 'Negotiation process of the 2021-2027 lon-term EU budget & NextGenerationEU' at ec.europa.eu/info/strategy/eu-budget/long-term-eu-budget/eu-budget-2021-2027_en. The Corona Recovery Fund (the European Union Recovery Instrument) was established by regulation (see Council Regulation (EU) 2020/2094 establishing a European Union Recovery Instrument to support the recovery in the aftermath of the COVID-19 crisis [2020] OJ LI 433/23, and Regulation (EU) 2021/241 of the European Parliament and of the Council of 12 February 2021 establishing the Recovery and Resilience Facility [2021] OJ L 57/17).

Countries that receive money through the multiannual budget or from the Corona Recovery Fund (whether in the form of loans or grants) are required to apply the European values of freedom and democracy in practice. They must have independent judges. The European Parliament had tightened up the requirement that the recipients must respect the rule of law. It is common knowledge that in Poland and Hungary the independence of the judiciary is under threat, freedom of the press is at risk and the rights of LGBTI people are being curtailed. These two countries have long threatened to exercise their right of veto to block the multiannual budget and the Corona Recovery Fund, because under the new agreements they could be punished in the future if they fail to adhere to the rule of law. On 10 December 2020, they dropped their opposition after everyone had agreed to a compromise proposal (perhaps too weak) put forward by Germany.[50]

So, is it a case of all's well that ends well? Not yet, because there's fresh trouble ahead. According to the German *Bundnis Bürgerwille* action group, the Corona Recovery Fund is contrary to European law and Germany runs the risk of having to raise the entire sum of EUR 750 billion if the other member states fail to do what they have agreed. At the request of this group, the German Constitutional Court (*Bundesverfassungsgericht / BVG*) has for the time being prohibited the head of state (*Bundespräsident*) from signing the

[50] For more details on this, see 'Akkord over begroting op top Europese Unie' (*NOS*, 10 December 2020), nos.nl/artikel/2360118-akkoord-over-begroting-op-top-europese-unie.html. But see also: Han Dirk Hekking, 'Europese Commissie broedt op snelle actie tegen Polen en Hongarije' (European Commission pondering rapid action against Poland and Hungary) (*FD*, 23 March 2021) 20; Ria Kats, 'Polen voor Europees Hof om ondermijning van de rechtsstaat' (Poland before the European Court of Justice for undermining the rule of law), (*FD*, 1 April 2021) 15.

law ratifying the German Corona Restoration Fund (*Hängebeschluss*). The next step is to institute proceedings on the merits before the BVG. If the BVG considers that EU law is at stake, it can submit questions about this to the European Court of Justice (CJEU) for a preliminary ruling. At the very least, all this could delay the moment when the Corona Recovery Fund becomes operational.[51]

But once (at some point) all obstacles have been removed, this means that the EU itself will place a sum of at least EUR 225 billion in green bonds to finance the Corona Recovery Fund, and will funnel the money raised in this way to green investments in the form of a grant or loan. Moreover, under the multiannual budget, at least EUR 322.2 billion will go to green projects over the next seven years. It is hoped that this will provide a boost for the green capital market.

But once again, the green transition will never be able to do without capital from the private sector. Businesses are currently fighting with all their might to keep their heads above water. Although the number of insolvencies is presently at an historical low,[52] at least in the Netherlands, this is inevitably due to the fact that a large part of the business community is being artificially kept alive by the various rounds of state aid (zombie

[51] See BverfG, 'Hängebeschluss zur Ausfertigung des Eigenmittelbeschluss-Ratifizierungsgesetzes' (Press release, 26 March 2021), bundesverfassungs gericht.de/SharedDocs/Pressemitteilungen/DE/2021/bvg21-023.html; see also 'BverfG untersagt dem Bundespräsidenten, das Gesetz zu unterschreiben' (*Büdnis Bürgerwille*, 26 March 2021), buendnis-buergerwille.de/bverfg-bundes praesidenten; and Daan Ballegeer, 'Karlsruhe zet rem op coronasteunpakket EU' (Karlsruhe puts brake on EU corona support package) (*FD*, 27 March 2021) 13.

[52] For more details about the Netherlands, see 'Hoeveel bedrijven per provincie werden failliet verklaard' at cbs.nl/nl-nl/faq/corona/regionaal/ faillissementen.

companies). Many people expect a wave of insolvencies, and not only in the Netherlands.[53] However, Klaas Knot, president of the Dutch central bank, recently intimated that he was not all that gloomy about the prospects for the Dutch economy.[54] Whatever the case, it is very much to be hoped that, in the coming period, the struggling business community will recognise just how essential the green transition is and make their contribution.

3.6 Towards a more sustainable world?

As is apparent from the Green Deal and the Sustainable Finance Action Plan (SFAP), the European Union sets the bar high when it comes to sustainability. Indeed, the Commission even considers that progress is not fast enough. Mid-way through this year, it is expected to publish an updated version of the SFAP. But the EU is not an island. Broadly speaking, two contrasting scenarios are conceivable. In a pessimistic scenario, the more flexible or even non-existent sustainability agendas of other geopolitical powers give them a competitive advantage detrimental to the EU. In an optimistic scenario, the EU will set

[53] For more details about the Netherlands, see PwC, 'Bijzonder Beheer Barometer' (November 2020), pwc.nl/nl/actueel-publicaties/assets/pdfs/pwc-bijzonder-beheer-barometer-nov-2020.pdf (Netherlands); Ryan Banerjee et al., 'Liquidity to solvency: transition cancelled or postponed?' (25 March 2021) BIS Bulletin no. 40, bis.org/publ/bisbull40.htm (international overview); Federico J. Diez et al., 'Insolvency Prospects Among Small-and-Medium-Sized Enterprises in Advanced Economies: Assessment and Policy Options' (2 April 2021) IMF, imf.org/en/Publications/Staff-Discussion-Notes/Issues/2021/03/25/Insolvency-Prospects-Among-Small-and-Medium- Sized-Enterprises -in-Advanced –Economies -50138 (international overview, but the Netherlands is not part of the study).

[54] See Marcel de Boer and Joost van Kuppeveld, 'Klaas Knot: Ik ga niet mee in het idee van een tsunami van faillissementen' (I don't buy into the idea of a tsunami of insolvencies) (*FD*, 23 March 2021) 13.

the sustainability standard worldwide.[55] Major institutional investors such as Blackrock and State Street say they are, in any case, strong supporters of the sustainability agenda.[56] And some hope is also provided by the fact that the United States rejoined the Paris climate agreement on 20 January following a decision by its 46th president Joe Biden.[57]

4. Digital Finance Package

4.1 General

On 24 September 2020, the Commission published its digital finance package.[58] Once again, this package of measures comes under the CMU umbrella and builds on the FinTech Action plan of March 2018.[59] The current plans (digital finance strategy) are also ambitious and set out four main priorities: (i) remove the fragmentation in the Digital Single Market; (ii) adapt the EU regulatory framework to facilitate digital innovation; (iii) promote data-driven finance; and (iv) address the challenges

[55] Cf. Anu Bradford, *The Brussels Effect – How the European Union Rules the World* (OUP 2020).

[56] See respectively: blackrock.com/corporate/literature/publication/blk-sustainability-mission-statement-web.pdf (Blackrock) and statestreet.com/values.html (States Street).

[57] See, e.g., The White House, 'Paris Climate Agreeement' (20 January 2020), whitehouse.gov/briefing-room/statements-releases/2021/01/20/paris-limate-agreement. See also the public statement of John Coates (Acting Director, Division of Corporation Finance, U.S. Securities and Exchange Commission, SEC), 'ESG Disclosure – Keeping Pace with Developments Affecting Investors, Public Companies and the Capital Markets' (11 March 2021) sec.gov/news/public-statement/coates-esg-disclosure-keeping-pace-031121.

[58] EC, 'Digital Finance Strategy for the EU' (Communication, 24 September 2020), COM(2020) 591 final, ec.europa.eu/info/publications/200924-digital-finance-proposals_en.

[59] EC, 'FinTech Action Plan: for a more competitive and innovative European financial sector' (Communication, 8 March 2018), COM(2018) 109 final.

and risks with digital transformation, including enhancing the digital operational resilience of the financial system.[60]

According to the Commission, the digital finance strategy will benefit not only new market participants but also consumers and SMEs. Embracing digital finance can only help to promote innovation in Europe, thereby creating opportunities to develop better financial products for consumers, including those who currently lack access to financial services ('financial inclusion'). The plans will also lead to new ways of financing European business, especially SMEs. More generally, the digital finance strategy will be able to ensure that supply and demand for capital can be matched more quickly in Europe, for example, when it comes to funding green plans. Geopolitical considerations also play a crucial role in the Commission's strategy. As Europe's hopes of maintaining its autonomy or even leading the way in setting global standards depend on its ability to counterbalance digital superpowers such as China, a competitive, innovative, digital, single market for financial services is vital. So, Europe's naivety is finally a thing of the past. The strategy also aims to guarantee a level playing field for providers of financial services, whether they be traditional banks or tech companies, under the motto 'same activity, same risks, same rules' (but see section 4.3 (ii), last words, below).[61] Amidst all this digital innovation, it is, of course, also important to strike the right balance between market access for new

[60] EC (n 58); and EC, 'Digital Finance Package: Commission sets out new, ambitious approach to encourage responsible innovation to benefit consumers and businesses' (Press release, 24 September 2020), ec.europa.eu/commission/presscorner/detail/en/IP_ 20_1684. As regards digital money and the digital finance package, see: Bart Bierens et al., 'Geld in beweging: actualiteiten geld en betalingsverkeer' (2021) Serie onderneming en Recht (to be published shortly).
[61] See previous footnote.

market participants and innovation through the use of artificial intelligence and blockchain on the one hand, and investor protection, financial stability and action to combat money laundering and cybercrime on the other.[62] But this is certainly no easy matter.

4.2 EU regulatory framework for Crypto-assets

(i) General

Parties that provide investment services and/or perform investment activities are known as investment firms under MiFID II rules. Both the services and the activities always relate to 'financial instruments'. It is apparent from the definition of 'financial instrument' that this is a fairly broad concept. It covers securities (in brief, negotiable shares and bonds) and, for example, all kinds of derivative products such as interest and currency swaps and even greenhouse emission rights.[63]

Although the definition of the term 'financial instrument' is broad, it does not cover all conceivable financial products. Crypto-assets (e.g., bitcoins) can often not be regarded as a 'financial instrument'. An entity that only provides services or performs activities regarding crypto-assets will often not be treated as an investment firm and will therefore not be subject to the MiFID II regime. Nor will the offering of crypto-assets to the public by means of a so-called initial coin offering (ICO) usually fall under the Prospectus Regulation, because that relates only to the offering of securities to the public. As already

[62] See previous footnote.
[63] See the definition of 'financial instrument' in section 1:1 (d) and (k) of the Financial Supervision Act. As regards the term 'financial instrument', see: Danny Busch and C. W. M. (Kitty) Lieverse, 'Chapter 1 – General' in Busch and Lieverse (2019), § 1.4.

noted, crypto-assets can often not be regarded as a financial instrument, and therefore not as a security (which is, after all, a 'species' of the financial instrument 'genus').[64]

However, this does not mean that market participants of this kind are not subject to any supervision whatsoever. In the Netherlands, providers of certain crypto-services (i.e. custodial wallet providers and providers engaged in exchange services between virtual currencies and fiat currencies, that is to say coins and banknotes that are designated as legal tender and electronic money of a country and accepted as a medium of exchange in the issuing country) have been subject to the Money Laundering and Terrorist Financing (Prevention) Act (Wwft) since 21 May 2020, thereby implementing the Fifth Anti-Money Laundering Directive.[65] Moreover, these providers of crypto-services fall under the Dutch Sanctions Act 1977

[64] For more about this, see M.A.R. (Marlinde) Nannings, 'Regulering van Initial Coin Offerings – Een raamwerk voor regulering door de kwalificatie van tokens als effect' (Regulation of Initial Coin Offerings - Creating a regulatory framework by defining e-money tokens as securities) (2018) Celsus juridische uitgeverij; E. P. M. (Bart) Joosen, 'Streng, strenger strengst' (2019) Tijdschrift voor Financieel Recht 2019/12; Willem Th. Röell, 'De uitgifte van tokeneffecten via een ICO als alternatieve vorm van ondernemingsfinanciering voor het MKB' (2019) Tijdschrift voor Financieel Recht 2019/10. For a recent article on the related issue of prospectus liability in the case of ICOs, see Sebastian Mock, 'Prospectus Liability and Initial Coin Offerings – Back to the Roots' (*OBLB*, 18 March 2021) law.ox.ac.uk/business-law-blog/blog/2021/03/prospectus-liability-and-initial-coin-offerings-back-roots. Articles 14, 22 and 47 of COM(2020) 593 final (MiCA) provide for European civil liability rules which are without prejudice to civil liability claims in accordance with national law. It remains to be seen whether these European liability rules make it to the finish line.

[65] Directive (EU) 2018/843 of the European Parliament and of the Council of 30 May 2018 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, and amending Directives 2009/138/EC and 2013/36/EU [2018] OJ L 156/43.

(Sw). As such, they must register with the Dutch central bank (DNB), which supervises compliance with both sets of rules.[66] According to some crypto-entrepreneurs, the registration requirement is more like an authorisation requirement, resulting in high costs and strict conditions. Crypto-company Bitonic has now filed a lawsuit against DNB for its crypto policy.[67]

(ii) Regulation on Markets in Crypto-assets (MiCA)

Moreover, if it is up to the European Commission, the issuance of crypto-assets and trading and services in relation to such assets will soon be regulated by the Regulation on Markets in Crypto-assets (MiCA).[68] This brings us to one of the initiatives behind the Digital Finance Package. The Commission makes a distinction between crypto-assets that are already covered by EU law (MiFID II, Prospectus Regulation and Market Abuse Regulation) and other crypto-assets. In the Commission's view, previously unregulated crypto-assets should come under the

[66] See DeNederlandscheBank (DNB), 'Money Laundering and Terrorist Financing (Prevention) Act and crypto' (4 May 2020), toezicht.dnb.nl/2/50-237963.jsp; and 'Sanctions Act and crypto' (11 November 2019), toezicht.dnb.nl/2/50-237925.jsp. See also, 'Supervision of crypto service providers', dnb.nl/voor-de-sector/open-boek-toezicht-sectoren/aanbieders-cryptodiensten; Anne M. F. Hakvoort, 'Tokenisation en het Nederlandse toezichtkader: een verkwikkende sprong in het diepe' (2021) Financieel Recht in de Praktijk 2021/2.

[67] See Rutger Betlem, 'Bitcoinhandelaar naar rechter om 'te strenge regels' van toezichthouder' (Bitcoin trader brings legal proceedings to challenge supervisor's 'unduly strict rules') (*FD*, 23 March 2021) 27; and 'Cryptobedrijf Bitonic: we gaan niet willens en wetens in tegen DNB' (Crypto company Bitonic: we're not deliberately picking an argument with DNB) (*FD*, 24 March) 21.

[68] EC, *Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and amenidng Directive (EU) 2019/1937 (MiCA)* (Proposal, 24 September 2020), COM(2020) 593 final.

MiCA Regulation.[69] However, the MiCA Regulation also contains specific rules for ‘stablecoins’ (asset-referenced tokens), even if they must be classified as electronic money within the meaning of the Electronic Money Directive (Directive 2009/110/EC).[70]

Under the proposed Regulation, (i) crypto-asset issuers and (ii) crypto-asset service providers are subject to an authorisation requirement and continuous supervision. Under the new rules, these market participants with an authorisation in one member state can operate throughout the EU/EEA (European passport). The rules proposed by the Commission are partly reminiscent of the rules from the Prospectus Regulation (for providers of crypto-assets), and partly of the MiFID II rules for investment services (for providers of crypto-asset services).[71] There are also market abuse rules for the trade in crypto-assets that resemble the rules from the Market Abuse Regulation.[72] But, here too, the rules are certainly not identical. Naturally, the fact that market participants of this kind will now be subject to European regulation and supervision is welcome, but if the MiCA Regulation enters into force in the proposed form there will still be no level playing field and the question is whether

[69] MiCA Regulation, Article 2, paras 1 and 2.
[70] MiCA Regulation, Article 2, paras 2, and Article 43 et seq.
[71] MiCA Regulation, Articles 15 et seq. and 53 et seq. respectively.
[72] MiCA Regulation, Article 76 et seq.

this is justified.[73] By the way, it should be noted that implementation rules (Level 2 rules) are being drawn up.[74]

(iii) A pilot regime for market infrastructures based on Distributed Ledger Technology

As I have already mentioned, the Commission considers that crypto-assets already covered by EU law (MiFID II, Prospectus Regulation and Market Abuse Regulation) should remain subject to the existing legislation, but it has proposed a pilot regime for DLT market infrastructures that wish to try to trade and settle transactions in financial instruments in crypto-asset

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[73] For a initial analysis of the MiCA Regulation, see, for example, S.W. van der Ven, 'Van MiFID naar Mica: een juridisch raamwerk' (2020) Tijdschrift voor Financieel Recht 2020/12; Dirk A. Zetsche, Filippo Annunziata, Douglas W. Arner and Ross P. Buckley, 'The Markets in Crypto-Assets Regulation (MiCA) and the EU Digital Finance Strategy' (2020) EBI Working Paper Series No. 2020/77; Joost Elsenburg and Bastiaan C. Van Schaik, 'An introduction to the MiCA proposal, the European Regulation on Markets in Crypto-Assets' (2021) Financieel Recht in de Praktijk 2021/2; and also DENTOS, 'Meet MiCA – The EU pushes forward its proposal for its Markets in Crypto-Assets Regulation plus a pilot regime for DLT infrastructure' (13 November 2020), dentons.com/en/insights/guides-reports-and-whitepapers/ 2020/november/13/background-briefing-meet-mica. See also ECB, *On a proposal for a regulation on Markets in Crypto-assets, and amending Directive (EU) 2019/1937* (Opinion, 19 February 2021), CON/2021/4. In which the ECB proposed all kinds of changes to the MiCA Regulation (see, for example, the ominous opening words on 1. '*(...) there are some aspects of the proposed regulation relating to the responsibilities of the ECB, the Eurosystem and the European System of Central Banks (ESCB) concerning the conduct of monetary policy, the smooth operation of payment systems, the prudential supervision of credit institutions and financial stability where further adjustments are warranted*'). For a discussion on the ECB's opinion, see DENTOS, 'ECB issues opinion on Markets in Crypto Assets Regulation (MiCA) and European Parliament Rapporteur tables own changes' (16 March 2021), dentons.com/en/insights/articles/2021/march/16/ecb-issues-opinion-on-markets-in-crypto-assets-regulation-eu-parliament-rapporteur-tables-cha nges.

[74] MiCA Regulation, Article 121.

forms. The pilot regime represents a so-called ‘sandbox’ approach – or controlled environment – which allows temporary derogations from existing rules. This will allow regulators to gain experience of the use of distributed ledger technology in market infrastructures, while ensuring that they can deal with risks to investor protection, market integrity and financial stability. The intention is to allow companies to test and learn more about how existing rules fare in practice.[75]

4.4 Digital Operational Resilience Act (DORA)

Tech companies are playing an ever greater role in the financial sector, not only because they provide ICT for financial institutions (such as banks, stock exchanges and fintechs) but also because they themselves are now providing financial services. The EU’s Digital Operational Resilience Act (DORA) is intended to provide all participants in the financial system with the necessary guarantees to limit cyber-attacks and other risks. Under the proposed legislation, all businesses must ensure that they can withstand all kinds of ICT disruptions and threats. The proposal also introduces a supervisory framework for ICT providers, such as providers of cloud computing services.[76]

[75] EC, *Regulation on a pilot regime for market infrastructures based on distribuited ledger technology* (Proposal, 24 September 2020), COM(2020) 594 final.

[76] EC, *Regulation on digital operational resilience for the financial sector* (Proposal, 24 September 2020), COM(2020) 595 final; EC, ‘Digital Finance Package: Commission sets out new, ambitious approach to encourage responsible innovation to benefit consumers and businesses’ (Press release, 24 September 2020), ec.europa.eu/commission/presscorner/detail/nl/IP_20_1684.

4.5 A Retail Payments Strategy: modern and cost-effective payments

The fourth and final element of the Digital Finance Package is a renewed retail payments strategy. The strategy aims to bring safe, fast and reliable payment services to European citizens and businesses. It will make it easier for consumers to pay in shops and make e-commerce transactions safely and conveniently. It seeks to achieve a fully integrated retail payments system in the EU, including instant cross-border payment solutions. This will facilitate payments in euros between the EU and other jurisdictions. According to the Commission, it will promote the emergence of home-grown and pan-European payment solutions and reduce Europe's dependence on global players in this field. Naturally, an important legislative step has already been taken in the form of the new Payment Services Directive (PSD2). However, PSD2 will be re-evaluated in the fourth quarter of 2021 and, if necessary, adjusted to support the implementation of the policies set out in the retail payments strategy.[77] All this will undoubtedly mean greater competition for traditional payment service providers such as banks.

[77] EC, 'A Retail Payments Strategy for the EU' (Communication, 24 September 2020), COM(2020) 592 final; ec.europa.eu/commission/press corner/detail/nl/IP_20_1684; and related documents on the EC's website at ec.europa.eu/info/publications/200924-digital-finance-proposals_en. As regards PSD2, see also: Emanuel J. van Praag, 'PSD2: naar open banking en bankieren in een ecosystem' (PSD2: towards open banking and banking in an ecosystem), (preliminary advisory report for the Financial Law Association (VvFR 2020) (VHI series, vol. 169, WoltersKluwer 2020).

5. Brexit

5.1 General

In its Brexit referendum on 23 June 2016, the United Kingdom announced its intention to leave the European Union. However, the road to the exit proved truly excruciating. Brexit did not become a reality until 1 January 2021. The UK had formally left the Union eleven months earlier (on 1 February 2020) on the basis of the Withdrawal Agreement, at which point it became a 'third country'.[78] But this withdrawal was immediately followed (under the terms of the Withdrawal Agreement) by a transition period during which everything was to remain the same or almost the same (from the perspective of EU law) until 31 December 2020 *unless* the parties decided before 1 July 2020 to extend the transition period for a maximum of 1 or 2 years, but that did not happen. Until the end of the transition period, the UK had access to the EU's financial markets in the same way as before 1 February 2020. That is, English financial institutions could offer their services in other member states without requiring a local authorisation, provided that they possessed an authorisation issued by the competent British regulator. In brief, the British authorisation therefore functioned as a 'European passport'. On 24 December 2020, a last-minute deal was concluded on the future trade relationship between the EU27 and the UK, thereby managing to avoid a so-called 'hard' Brexit (i.e., no trade deal at all) at the eleventh hour. However, the deal contained no agreements about British access to the EU's financial markets (and vice versa). Despite the trade deal, the UK's departure from the EU qualifies as a hard Brexit for

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[78] See Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community, OJ C 384 I, 12.11.2019, 1.

the financial sector because authorisations issued by the competent UK regulator have no longer functioned as a European passport since 1 January 2021.[79]

British financial institutions had, of course, seen the storm coming for quite some time. For years, they did not know whether they would retain their access to the EU. In recent years, many of these institutions therefore transferred assets and activities to authorised group companies in the EU27. And the end of this migration wave does not yet seem in sight. For those institutions that judged a move to mainland Europe would prove unprofitable, there was sometimes no other option than to cut ties with their European clients. This was why many British banks closed the bank accounts held with them by clients in mainland Europe.[80] How Brexit will work out in the long term for the City of London and for the financial sector in the EU27 remains to be seen, but the first shifts are already visible. Amsterdam has overtaken London as the centre for European equity trading. Figures published by EY also show that banks, insurers and other financial institutions have to date moved assets totalling EUR 1,500 billion to the EU27. A quarter of the large companies in the City of London have been adversely affected by Brexit. According to British merchant bankers, companies wanting a stock exchange listing are now more

[79] For the Trade Agreement, see OJ EU 2020, L 444. See also Rijksoverheid, 'Brexit – EU – VK akkoord: stand van zaken', rijksoverheid.nl/onderwerpen/brexit/brexit-stand-van-zaken.

[80] For more on this, see Eva Wiessing and Thom Opheikens, 'Brexit nadert: Britse banken heffen plotseling rekening van Nederlandse klanten op' (NOS, 24 September 2020), nos.nl/artikel/2349658-brexit-nadert-britse-banken-heffen-plotseling-rekening-van-nederlandse-klanten-op.html.

inclined to come to Amsterdam because the rules on Euronext are more flexible.[81]

The EU and the UK can declare each other's legislation and supervision in a number of sub-areas to be equivalent, thereby making market access comparable to that available with the European passport possible in a limited number of areas. However, these so-called equivalence decisions are unilateral and were therefore not part of the negotiations on the future partnership.[82]

5.2 An equivalence decision for British central clearing counterparties (CCPs)

It should be noted, however, that due to the risks to financial stability, the European Commission adopted a time-limited (18-month) equivalence decision on behalf of central clearing counterparties (CCPs) established in the UK.[83] CCPs play a central role in the clearing of standardised OTC derivatives transactions. By way of follow-up, ESMA recognised the three UK CCPs (ICE Clear Europe Limited, LCH Limited and LME Clear Limited) as third-country CCPs on 28 September 2020,

[81] Joost Dobber, 'De City wil niet nog meer handelsterrein verliezen' (City of London averse to losing even more ground to trading rivals) (*FD*, 3 March 2021) 2-3.

[82] For more on this, see Rijksoverheid, 'Kamerbrief beoordeling Handels- en Samenwerkingsovereenkomst EU-VK' (27 December 2020), rijksoverheid.nl/ministeries/ministerie-van-buitenlandse-zaken/documenten/kamerstukken/2020/12/27/kamerbrief-beoordeling-handels--en-samenwerkingsovereenkomst-eu-vk.

[83] See Commission Implementing Decision (EU) 2020/1308 of determining, for a limited period of time, that the regulatory framework applicable to central counterparties in the United Kingdom of Great Britain and Northern Ireland is equivalent, in accordance with Regulation (EU) No 648/2012 of the European Parliament and of the Council [2020] OJ L 306/1. OTC stands for 'over the counter'.

namely until 30 June 2022.[84] This means that the British CCPs may, at least provisionally, continue to provide clearing services to their clients in the EU27. And that is a good thing, as a very sizeable volume of euro-denominated OTC derivatives transactions are cleared by CCPs in the UK. The estimated daily values of repos and interest rate swaps denominated in euros are EUR 101 billion and EUR 33 trillion respectively (approximately 99% of the Union market).[85] If the Commission had not taken an equivalence decision, this would have meant that a staggering volume of transactions would suddenly have had to be cleared all at once through CCPs within the EU27. This would have been a very costly and complex operation, which could also have threatened financial stability if it had been done precipitately. Moreover, it is highly questionable whether sufficient capacity currently exists within the EU27.

[84] ESMA, Press release, *ESMA to recognise three UK CCPS from 1 January 2021* (28 September 2020) ESMA77-99-1403. On 25 November 2020, pursuant to the Central Securities Depositories Regulation (Regulation (EU) No 909/2014), the Commission also adopted a time-limited equivalence decision for the regulation and supervision of central securities depositories (CSDs) established in the UK. On this basis, ESMA recognised Euroclear UK and Ireland Limited (EUI) as third-country CSDs (until 30 June 2021). See ESMA, ESMA to recognise Euroclear UK and Ireland Limited (EUI) after Brexit transition period (Press release, 11 December 2020) ESMA71-99-1483: 'This time period should give concerned EU issuers sufficient time to transfer their securities to EU CSDs.' So an extension of the equivalence decision for British CSDs does not seem to be on the cards. A CSD or central securities depository is an institution that specialises in holding securities for the purpose of allowing clearing and settlement to be performed electronically. As regards the activities of EUI, see EUI's website at euroclear.com/services/ en/provider-homepage/euro clear-uk-ireland.html.

[85] At any rate in 2017. See EC, 'Mid-Term Review of the Capital Markets Union Action Plan' (Communication, 8 June 2017), COM(2017) 292 final, 6.

Be that as it may, British CCPs do not have to move to the European mainland for the time being in order to continue to service clients in the EU27. But whether that will remain the case is the question. The position is as follows. The European Market Infrastructure Regulation (EMIR) was amended on 10 October 2019 in such a way that third-country CCPs established in countries for which the Commission has adopted an equivalence decision (such as the UK) should be divided into two groups: systemically relevant (Tier-2 CCPs) and non-systemically relevant (Tier-1 CCPs). If a third-country CCP is not systemically relevant, there are no additional requirements for recognition by ESMA of a CCP in that third country. The CCP can then operate within the Union on the basis of compliance with the rules of its home country and need not additionally comply with the European rules under EMIR. This is different once ESMA considers that a third-country CCP is or will become systemically relevant. In that case, the CCP must fulfil additional requirements in order to be allowed to start or continue operating in the Union, including compliance with the strict prudential EMIR requirements that also apply to CCPs established in the EU. As soon as a third-country CCP becomes so systemically relevant in ESMA's opinion that even compliance with the prudential EMIR provisions is insufficient, ESMA (in consultation with the relevant central banks) can advise the Commission to take a decision that the third-country CCP may no longer operate in the Union unless it establishes itself in the EU27.[86] It will be clear that this change is a direct

[86] Regulation (EU) 2019/2099 of the European Parliament and of the Council amending Regulation (EU) No 648/2012 as regards the procedures and authorities involved for the authorisation of CCPs and requirements for the recognition of third-country CCPs [2019] OJ L 322/1.

response to Brexit. The key question is, of course, whether the main British CCPs fall into this strictest category.

The exact standard to be applied by ESMA in assessing whether a third-country CCP is or will become systemically relevant is specified in implementing legislation (Level 2 rules) published on 21 September 2020.[87] When ESMA recognised the three British CCPs as third-country CCPs on 28 September 2020 (see above), the exact standard was thus already known. ESMA's recognition decision therefore states how these CCPs are classified. LME Clear Limited is classified as a Tier 1 CCP and is therefore not systemically relevant, but ICE Clear Limited and LCH Limited are both classified as Tier 2 CCPs and are therefore systemically relevant. But how systemically relevant are they exactly? ESMA will investigate this in the near future. Suppose the outcome of that investigation is that ICE Clear Limited and LCH Limited are or will become of such systemic importance that even compliance with the prudential EMIR provisions is insufficient. In that case, ESMA (in consultation with the relevant central banks) may advise the Commission to decide that these two British CCPs should no longer be allowed to operate in the Union. The only way for these CCPs to continue operating in the EU27 will be to move to a city within the EU27 (e.g., Paris or Milan), apply for an EMIR authorisation in that country, and then fully submit to the EMIR regime. This would then herald a dramatic shift in the UK's

[87] Commission Delegated Regulation (EU) 2020/1303 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council with regard to the criteria that ESMA should take into account to determine whether a central counterparty established in a third country is systemically important or likely to become systemically important for the financial stability of the Union or of one or more of its Member States [2020] OJ L 305/7.

clearing sector to the EU27 (and to the US as CCPs there have equivalence with both the EU and the UK).[88] Similarly, relocation will be the only option if the Commission does not extend the current equivalence decision (valid until 30 June 2022).[89] LCH Limited has already set up a subsidiary in Paris to be able to clear transactions in mainland Europe (LCH SA).[90]

5.3 Additional equivalence decisions?

Under the European rules, the Commission could also adopt equivalence decisions in relation to the rules and supervision in the UK for other types of financial institution.[91] In making its equivalence assessment, the Commission takes into account the implications for financial stability, market transparency and

[88] See Matthijs Rotteveel, 'Europese Unie speelt hoog spel in strijd met VK om rentederivaten' (EU playing high stakes game in battle with UK over interest rate derivatives) (*FD*, 29 March 2021) 27. For the record, I would note that a regulation has now also been adopted concerning the recovery and orderly resolution of CCPs. See Regulation (EU) 2021/23 of the European Parliament and of the Council on a framework for the recovery and resolution of central counterparties [2020] OJ L 22/1. For more about this, see Jens-Hinrich Binder, 'Chapter 12 - Central Counterparties Insolvency and Resolution in the EU' in Binder and Saguato (2021).

[89] According to the ECB, the market should not expect the Commission to extend the equivalence decision for British CCPs; see Rebekah Tunstead, 'ECB: don't expect equivalence extension for UK CCPs' (*Risk.net*, 24 March 2021), risk.net/derivatives/7814796/ecb-dont-expect-equivalence-extension-for-uk-ccps.

[90] For more details, see LCH's website at lch.com/about-us/our-clearing-houses.

[91] On this point, see Eddy Wymeersch, 'Third-Country Equivalence and Access to the EU Financial Markets Including in Case of Brexit' (2018) 4(2) Journal of Financial Regulation 209-275; Elizabeth Howell, 'Post-Brexit UK Fund Regulation: Equivalence, Divergence or Convergence? (2020) 21 European Business Organization Law Review 611-639; F. Pennesi, 'Equivalence in the area of financial services: An effective instrument to protect EU financial stability in global capital markets?' (2021) 58(1) Common Market Law Review 39-70.

integrity, investor protection and a level playing field, while maintaining a forward-looking approach.[92] The latter addition is crucial. As the rules applicable to the British financial sector do not yet differ fundamentally from those in force before Brexit, equivalence often exists at present. But it seems likely that this will not continue. The City of London does not want to lose its leading position, and is now critically scrutinising the rules for the British financial sector. For example, it wishes to offer founders of fast-growing FinTechs more opportunities to retain control over their company even after an IPO and to make it easy to bring 'special purpose acquisition companies' (SPACs) to the British stock exchange. Spacs are also known as 'blank check companies'. These are shell companies listed on a stock exchange with the aim of acquiring and then incorporating a privately owned business, thereby avoiding the traditional process of an IPO. The rules for listing a SPAC on Euronext Amsterdam are currently more flexible than in London. The UK is also currently considering adjusting the rules for insurers. It therefore seems that the European and UK rules for the financial sector will diverge still further in the near future. Additional equivalence decisions of the Commission are therefore not expected for the time being. As agreed in the trade deal, the parties have now concluded a memorandum of understanding laying the foundation for further cooperation in this area. It is doubtful whether this provides a basis for additional equivalence decisions. At present, the Union appears to have little to gain from adopting a conciliatory approach towards the UK.[93].

[92] See Rijksoverheid (82).
[93] Joost Dobber, 'De City wil niet nog meer handelsterrein verliezen' (City of London averse to losing even more ground to trading rivals) (*FD*, 3 March

6. A European deposit insurance scheme, bad loans and the coronavirus crisis

6.1 Towards a European deposit insurance scheme?

The coronavirus crisis has been bad news for the European Banking Union (EBU). EBU has not yet been completed as the third pillar – a European deposit insurance scheme (EDIS) – is still not in place. Under the existing EU Directive on deposit insurance schemes, it is already the case that if a bank in the EU is unable to meet its payment commitments, an aggrieved depositor (saver) can recover up to a maximum of EUR 100,000 from the deposit insurance fund. Each member state has (or should have) set up such a fund, which the banks jointly finance in that member state. The idea now is that the financing of the deposit insurance scheme within the euro area should be elevated to the European level.[94] But the Netherlands and Germany, in particular, are unenthusiastic. If an Italian, Spanish, Portuguese, or Greek bank goes bankrupt, the Dutch and German banks would have to contribute. The Netherlands and Germany have always made clear that they would agree to an EU-funded deposit insurance scheme only if the non-

2021) 2-3; Philip Stafford, 'UK and EU begin diverging on financial regulation after Brexit' (*Financial Times*, 26 March 2021) ft.com/content/9dcefb24-59ff-4527-bebf-9efdf875aa37; Jim Brundsen and Peter Foster, 'UK and EU reach financial regulation deal in break-through on co-operation' (*Financial Times*, 26 March 2021) ft.com/content/4222515b-e501-4b7f-82ce-f94810f4a819.

[94] For the Commission's initial proposal, see EC, *Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme* (Proposal, 24 November 2015) COM(2015) 586 final. For more about this, see Veerle Colaert, 'Chapter 14 - European Deposit Insurance System (EDIS): third pillar of the Banking Union or dead end?' in Busch and Ferrarini (2020).

performing loans (NPLs[95]) on bank balance sheets, particularly those of the south European banks, are reduced to acceptable proportions. Spain, Italy, and Portugal were well on the way to reducing the proportion of NPLs on their banks' balance sheets, which had in any event improved the prospect of the EBU's third pillar being introduced. However, the coronavirus crisis has caused the share of NPLs on bank balance sheets across Europe to rise sharply again.[96] After all, many European businesses and households that have borrowed money from banks have encountered payment problems due to the pandemic. In Greece, insufficient progress has been made in recent years in consolidating bank balance sheets, and the current crisis is only adding to the problems.[97] José Manuel Campa, the European Banking Authority (EBA) chair, has recently voiced concerns about this, calling it 'utterly paradoxical' that the share of NPLs in the euro area fell to the exceptionally low level of 2.6% at the end of last year. He has called on European banks to look more critically at their loan portfolios and, where necessary, take their losses immediately.[98]

95 NPLs (non-performing loans) are bank loans that are subject to late repayment (90 days past due) or unlikely to be repaid by the borrower, if, for example, the borrower faces financial difficulties. See the EC's Q&A page at ec.europa.eu/comm ission/presscorner/detail/en/QANDA_20_2376.

96 See EC, 'Tackling non-performing loans in the aftermath of the COVID-19 pandemic' (Communication, 16 December 2020) COM(2020) 822 final, 5-6.

97 See ibid table 1 at 6.

98 See Marcel de Boer, Toezichthouder: zombiebedrijven kunnen ook de banken aantasten (Supervisor: zombie companies can also harm the banks) (*FD*, 23 March) 27; see also Silla Brusch, 'European Banks Urged to Recognize Loan Losses Following Covid' (*Bloomberg*, 22 March 2021), bloomberg.com/news/articles/2021-03-22/european-banks-urged-to-recognize-loan-losses-following-covid. Similarly, see Andrea Enria (chair of the Supervisory Board of the ECB), 'European banks in the post-COVID-19 world' (Speech at the Morgan Stanley Virtual European Financials

Whatever the case, if the share of NPLs on European bank balance sheets increases again, a European-funded deposit insurance scheme will also be further away than ever, although the Commission has put the subject back on the agenda in a recent consultation document. As an intermediate step, thoughts are currently turning to a 'hybrid' model, in which EU liquidity support is provided to national deposit insurance funds that need it.[99]

6.2 A European bad bank?

Naturally, a crisis can also lead to greater centralisation. Indeed, there are once again calls for a so-called European bad bank (European Asset Management Company or AMC) to be set up as a receptacle for all non-performing loans.[100] The idea is that

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Conference, Frankfurt am Main, 16 March 2021), bankingsupervision.europa.eu/press/speeches/date/2021/html/ssm.sp210316~55c3332593.en.html; and DNB, 'Overzicht Financiële Stabiliteit' (Autumn 2020) 20, dnb.nl/media/faxpn0vj/ofs_najaar__2020.pdf; Marcel de Boer, 'EBA ziet voorbode van meer afboekingen bij banken' (EBA sees portent of more bank write-downs) (*FD*, 31 March 2021).

[99]See EC, *Targeted consultation on the review of the crisis management and deposit insurance framework*, 32 et seq., ec.europa.eu/info/consultations/finance-2021-crisis-management-deposit-insurance-review-targeted_en. The ECB is already in favour of a hybrid model as an intermediate step; see Luis de Guindos (Vice-President of the ECB), 'Banking Union: achievements and challenges' (Speech at the High-level conference on "Strengthening the EU's bank crisis management and deposit insurance framework: for a more resilient and efficient banking union" organised by the European Commission, 18 March 2021), ecb.europa.eu/press/key/date/2021/html/ecb.sp210318_1~e2126b2dec.en.html.

[100] See 'Greek central bank president advocates a European bad bank' (*FD*, 19 April 2020); 'Moet politiek ingrijpen om banken van giftige leningen af te helpen?' (Should politicians intervene to help banks jettison toxic debts?) (*FD*, 22 April 2020). The establishment of a European bad bank has also been advocated by the Chair of the ECB'a Supervisory Board, see Andrea Enria 'ECB: the EU needs a regional bad bank' (*Financial Times*, 26 October 2020) ft.com/content/cc3a9a51-4d9a-4c73-9ff0-9f623ecf4065. See also Antonio

the pain will then be shared across Europe. Whether this form of solidarity is feasible remains to be seen. But one thing is certain: the problem that the share of non-performing loans on European bank balance sheets is likely to rise again due to the coronavirus crisis will not disappear by doing anything. The publication by the European Commission of an NPL action plan on 16 December 2020 to address this problem is, therefore, to be welcomed.[101] The action plan builds on the 2017 European Council NPL strategy.[102]

6.3 How do we keep bank lending up to standard?

Before considering this, we need to take a few steps back. As already noted, many European businesses and households have come under great financial pressure as a result of the pandemic. It is therefore necessary to ensure that they have access to the funding they need during the crisis. Besides all kinds of state aid (facilitated by a more flexible application of European rules) and payment deferrals (moratoriums), maintaining the volume of bank lending is essential. In Europe, efforts are being made to achieve this by relaxing the EU banking rules and/or their application, for example by providing favourable prudential treatment for non-performing loans if they are covered by

Carrascosa, former Member of the Single Resolution Board (SRB), 'A European Bad Bank – a necessary tool for financial stability?' (*SRB*, 28 December 2020), srb.europa.eu/en/node/1109. The same goes for Elke König, Chair of the SRB, see speech by Elke König at the EBI Policy Conference, 'Europe and the Covid-19 crisis' (5 November 2020), srb.europa.eu/en/node/1080. As regards NPLs, see Emilios Avgouleas, 'Chapter 8 - The EU framework dealing with non-performing exposures' in Busch and Ferrarini (2020).

[101] EC (n 96).

[102] ECOFIN Council, *Action Plan to Tackle Non-Performing Loans in Europe* (July 2017), consilium.europa.eu/en/press/press-releases/2017/07/11/conclusions-non-performing-loans.

government guarantees, and by flexible application of international accounting standards (IFRS9).[103] On the other hand, the standards should not be applied too flexibly, because banks must naturally continue to look realistically at their loan portfolios and, where necessary, immediately take their losses (see section 7.1, above).

6.4 The NPL action plan

However, more is needed to maintain the volume of bank lending. This is why the Commission published its NPL action plan on 16 December 2020. The plan has four main goals.

(i) Further develop secondary markets for distressed assets

First, the NPL action plan envisages further developing the secondary markets for distressed assets. A deeper and more liquid secondary market for distressed assets would provide banks with the possibility to reduce their NPLs by selling them to third-party investors. This would create room on the bank balance sheets for new lending, enabling them to fund the economic recovery.[104]

Reaching agreement quickly on the Commission's proposal for a Directive on credit servicers, credit purchasers and the

[103] See EC (n 96) 1 (with further references). As regards the European coronavirus measures, see Christos V. Gortsos and Wolf-Georg Ringe (eds), *Pandemic Crisis and Financial Stability* (EBI 2020) ebi-europa.eu/ebi-e-book-series; E.P.M. (Bart) Joosen and C.W.M. (Kitty) Lieverse, 'De coronacrisis en de versoepeling van de prudentiële eisen voor banken' (2020) Ondernemingsrecht 2020/VIII; Danny Busch, 'Wat doet de Europese Unie ter bezwering van de coronacrisis' (2020) Nederlands Juristenblad 1444-1455; see also EBI's Covid Report at ebi-europa.eu/update-ebi-covid-report-7.

[104] See EC (n 96) 7.

recovery of collateral, which was adopted in March 2018,[105] will be a vital step. This proposal ensures that, if a loan is sold, debtor protection across the single market is not weaker than the protection offered by the initial lending bank. It would ensure that consumer protection obligations are upheld irrespective of how NPLs are resolved.[106] As regards this proposal, see also point (ii) and section 7.5 below.

As part of the Capital Markets Recovery Package of 24 July 2020 (see section 2.9 above), the Commission also proposed targeted improvements to the securitisation framework for banks' non-performing exposures.[107] Securitisation is a technique that enables banks to consolidate loans, convert them into securities and sell them on the capital markets, thus removing them from their balance sheets. NPLs are part of a wider set of non-performing exposures (NPEs). Such exposures could include, for example, not only loans but also other debt instruments such as a debt security, an advance, and a demand deposit. An agreement was reached on this in December 2020, the idea being that these adjustments should make it easier for banks to remove NPLs from their balance sheets.[108]

The Commission considers that there would be merit in establishing a central electronic data hub at EU level to increase transparency in the NPL market. Such a hub would act as a data

[105] EC, *Directive on credit servicers, credit purchasers and the recovery of collateral* (Proposal, 14 March 2018) COM(2018) 0135 final.
[106] See EC (n 96) 7.
[107] EC, *Regulation amending Regulation (EU) 2017/2402 on securitisation* (Proposal, 24 July 2020) COM(2020) 282 final; and EC, *Regulation amending Regulation (EU) No 575/2013 on adjustments to the securitisation framework to support recovery in response to the COVID-19 pandemic* (Proposal, 24 July 2020) COM(2020) 283 final. See also Action 6 of the CMU Action Plan.
[108] See EC (n 96) 7.

repository underpinning the NPL market and allowing a better exchange of information between all market participants involved (credit sellers, credit purchasers, credit servicers, national asset management companies (AMCs) and private NPL platforms), thereby ensuring that NPLs can be disposed of effectively. On the basis of a public consultation, the Commission will explore several alternatives for establishing a data hub at the European level in order to determine the best way forward.[109]

(ii) Reform the EU's corporate insolvency and debt recovery legislation

Second, the NPL action plan proposes to reform the EU's corporate insolvency and debt recovery legislation so that the various insolvency frameworks across the EU converge while maintaining high consumer protection standards. More convergent insolvency procedures would increase legal certainty and speed up the recovery of value for the benefit of both the creditor and the debtor. The Commission urges the Parliament and the Council to reach an agreement swiftly on the legislative proposal for minimum harmonisation rules on accelerated extrajudicial collateral enforcement, which the Commission proposed as long ago as 2018. By the way, it should be noted that consumers are entirely excluded from this accelerated enforcement procedure.[110]

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[109] See EC (n 96) 7-12; and EC, 'Action plan: Tackling non-performing loans (NPLs) in the aftermath of the COVID-19 pandemic' (Communication, 16 December 2020), ec.europa.eu/info/publications/201216-non-performing-loans-action-plan_en.

[110] See EC (n 96) 15-17; and EC, Communication (n 109). For the 2018 proposal, see EC (n 105). For more about this, see Ben Schuijling, Vincent Van Hoof and Tom Hutten, 'Non-performing loans and the harmonisation of

(iii) Support the establishment and cooperation of national asset management companies (AMCs)

Third, the NPL action plan proposes support for the establishment and cooperation of national AMCs at the EU level. Asset management companies are vehicles that provide relief to distressed banks by enabling them to remove NPLs from their balance sheets. This helps them to re-focus on lending to viable firms and households instead of managing NPLs. The Commission is prepared to support member states in setting up national AMCs, if they wish to do so, and would explore how cooperation could be fostered by establishing an EU network of national AMCs. While national AMCs are valuable because they benefit from domestic expertise, an EU network of national AMCs could enable national entities to exchange best practices, enforce data and transparency standards and better coordinate actions. A network of AMCs could also use the data hub to coordinate and cooperate their activities with each other in order to share information on investors, debtors and servicers. Accessing information on NPL markets will require that all relevant data protection rules regarding debtors are respected.[111]

extrajudicial collateral enforcement across Europe' (2019) 28(3) International Insolvency Review 340, 341 et seq.; cf. also section 2.3 above.

[111] See EC (n 96) 15-17; and EC, Communication (n 109). For more about national AMCs, see in this volume, 'Non-performing loans: new risks and policies' by Emilios Avgouleas et al.; and also Christos V. Gortsos, 'Non-performing loans: new risks and policies? What factors drive the performance of national asset management companies?', Economic Governance Support Unit (EGOV) Directorate-General for Internal Policies PE 659.647 - March 2021.

(iv) Implement precautionary public support measures

Finally, the NPL action plan proposes to facilitate the provision of state aid to banks. Given the exceptional nature of the pandemic, authorities must have the possibility to implement precautionary public support measures, where needed, to ensure the continued funding of the real economy. This support can naturally be granted only if it is permitted under the Bank Recovery and Resolution Directive (BRRD) and the European rules on state aid.[112] In the Commission's view, both sets of rules allow scope for the provision of state aid, given the special circumstances. The Commission indicates how the rules should be interpreted in the light of the coronavirus crisis and basically calls on the member states in its NPL Action Plan to make use of this scope when necessary.[113]

7. Conclusion.

At the start of this chapter, I noted that the main themes of our time are playing a defining role in financial law as well: the coronavirus crisis, sustainability, the onward march of technology, the unceasing struggle between integration and

[112] For a recent discussion of this subject, see Marije Louisse-Read, *Public funding of failing banks in the European Union* (thesis, Radboud University, Nijmegen) (Law of Business and Finance vol. 19, Kluwer 2020).

[113] See EC (n 96) 17-20; and EC, Communication (n 109). It is also interesting in this context that the CJEU recently shied away from intervening in an Italian support scheme established for Italian banks under private law in 2014. Although, according to a Commission decision dating from 2015, this arrangement did amount to the provision of prohibited state aid by the Italian authorities, both the court of first instance and the CJEU ruled that this was not the case because the scheme was not imputable to the Italian state, and there had also been no circumvention of the BRRD. See CJEU 2 March 2021, C-425/19 P *Commission v Italy and Others* [2021], ECLI:EU:C:2021:154 (*Tercas*).

federalism on the one hand and protectionism and nationalism on the other and, last but not least, the pressure exerted by major geopolitical powers such as China, the United States and Russia. As I pointed out, these forces have largely shaped financial law in Europe in the recent past and will continue to do so in the future. Where these forces are actually leading is, however, less easy to predict. It remains to be seen whether all the new European rules and legislative proposals will produce a fully integrated, sustainable, and digital European Capital Markets Union and a complete and smoothly functioning European Banking Union. And it is still much too early to gauge whether Brexit will work out well for the EU27. But one thing is certain: Europe's tentacles reach deep into financial law. No matter what finance-related topic one studies, whether it be issues such as deposit insurance schemes, non-performing loans or the coronavirus crisis, one is bound sooner or later to have to deal with EU law. And I have not even got around to mentioning the new European prudential rules for investment firms that will become applicable on 26 June 2021 (IFR/IFD) or the MiFID II, MAR, AIFMD, Solvency II and BRRD / SRMR review.[114] In

[114] See Regulation (EU) 2019/2033 of the European Parliament and of the Council on the prudential requirements of investment firms (Investment Firm Regulation, IFR) [2019] OJ L 314/1; Directive (EU) 2019/2034 of the European Parliament and of the Council on the prudential supervision of investment firms (Investment Firm Directive, IFD) [2019] L 314/64. For the reviews of MiFID II (Markets in Financial Instruments Directive), MAR (Market Abuse Regulation), AIFMD (Alternative Investment Fund Managers Directive), Solvency II (EU rules for insurers and re-insurers) and BRRD/SRMR (Bank Recovery and Resolution Directive/Single Resolution Mechanism Regulation), see respectively: EC, *Review of the regulatory framewrok for investment firms and market operators*, ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12167-Review-of-the-regulatory-framework-for-investment-firms-and-market-operators-MiFID-2-1-/public-consultation; ESMA, *Consultation MAR Review*, esma.europa.eu/press-news/consultations/consultation-mar-review; EC, *Financial*

other words, for practitioners of financial law and academics conducting research in this field, the need to deal with EU law is simply a fact of life. As long as the European Union continues to exist, of course.

services – review of EU rules on alternative investment fund managers (Consultation, 2021), ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12648-Alternative-Investment-Fund-Managers-review-of-EU-rules/public-consultation_en; EIOPA, *2020 review of Solvency II* (17 December 2020), eiopa.europa.eu/browse/solvency-ii/2020-review-of-solvency-ii_en; and EC (n 99). The last of these reviews also deals with a deposit insurance scheme, possibly funded by the EU. This topic has been briefly discussed in section 6.1 above.

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SECTION II:
NON-PERFORMING LOANS

5. Non-performing loans: new risks and policies*

Emilios Avgouleas, Rym Ayadi, Marco Bodellini, Giovanni Ferri, Barbara Casu, and Willem Pieter De Groen

* * *

1. Introduction

Systemic macro-financial crises cause severe swings in levels of economic activity, thereby amplifying the volume of non-performing loans (NPLs) in national banking systems. The ensuing NPL burden could endanger the health and stability of banking systems. In most cases, asset management companies (AMCs) have proved to be an effective way of managing those large portfolios of NPLs burdening relevant parts of national banking systems. At the same time, this is an endeavour fraught with difficulty in the European Union (EU) given the restrictions placed on public support by the State aid regime.

To overcome these restrictions and to create a fairer burden-sharing structure, while alleviating the governance problems that often plague AMCs, Avgouleas and Goodhart proposed the

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creation of a pan-European holding company participating in the capital of national AMCs along with domestic banks wishing to transfer their NPLs to the AMC.[1] The holding company would be owned by Member States whose participation in the share capital of the AMC would vary depending on a combination of their GDP and the ratio of NPLs to total loans of the country's banking sector. To overcome any criticism that such an initiative would cause loss mutualisation among Member States, the proposal suggests that losses or profits of each AMC be cleared at the national level.

More recently, Andrea Enria, during a public hearing before the Committee on Economic and Monetary Affairs (ECON) of the European Parliament, reiterated his proposal[2] to overcome the NPLs issue. Either a European AMC or a network of national AMCs should be established. Once the COVID-19 economic relief measures implemented in many Member States are lifted, as Enria pointed out, a new wave of distressed bank loans will certainly emerge. With the national AMC network alternative, Enria argued that mechanisms to avoid loss mutualisation among Member States could also be designed, if this was the political will. In his view, common funding of national AMCs

[1] See Emilios Avgouleas and Charles Goodhart, 'An Anatomy of Bank Bail-ins: Why the Eurozone Needs a Fiscal Backstop for the Banking Sector' (2016) 2 European Economy – Banks, Regulation, and the Real Sector 75; and Emilios Avgouleas and Charles Goodhart, 'Utilizing AMCs to Tackle the Eurozone's Legacy Non-Performing Loans' (2017) 1 Banks, Regulation, and the Real Sector 97.

[2] See Andrea Enria, 'Hearing at the European Parliament's Economic and Monetary Affairs Committee' (Introductory statement by Andrea Enria, Chair of the Supervisory Board of the ECB, 27 October 2020), bankingsupervision.europa.eu/press/speeches/date/2020/html/ssm.sp201027~d284d6d6c8.en.html. Enria has already presented this proposal in an article published in the Financial Times. See Andrea Enria, 'ECB: the EU needs a regional 'bad bank'' (*Financial Times*, 26 October 2020).

(guaranteed or provided by a central body) and harmonised pricing would be key to ensuring a level playing field within the Banking Union.

A new generation of NPLs is bound to emerge in the Union due to the COVID-19 crisis.[3] In December 2020, the European Commission published an Action Plan,[4] where it holds AMCs as one of the tools to tackle the expected accumulation of NPLs, also recalling the AMC blueprint drafted in 2018. For coordination purposes, the Commission has suggested the creation of a loose EU-wide network of national AMCs with a view to benefiting from synergies and economies of scale gained from data sharing and the exchange of best practices and experiences.

The remainder of this chapter is as follows: Section 2 offers an analysis of the advantages and disadvantages of AMCs. Section 3 provides an assessment of their design. Section 4 compares the characteristics and performance of national AMCs in the EU. Section 5 draws the main conclusions and recommends a number of ways to facilitate the creation of AMCs to deal with the new generation of NPLs.

[3] See EC, 'Tackling non-performing loans in the aftermath of the COVID-19 pandemic' (Communication from the Commission to the European Parliament, the Council and the European Central Bank, 16 December 2021) COM (2020) 822 final.

[4] See EC, *Commission Staff Working Paper, AMC Blueprint, Accompanying the document, Communication from the Commission to the European Parliament, the Council and the European Central Bank, Second Progress Report on the Reduction of Non-Performing Loans in Europe* (Staff Working Paper, 14 March 2018) SWD(2018) 72 final, 5 (where it is stressed that AMCs could produce a particularly effective result in relation to NPLs concerning commercial real estate and large corporate exposures).

2. Advantages and disadvantages of AMCs

AMCs have been widely used to manage the accumulation of NPLs. However, NPL management faces several challenges. Low liquidity and depressed markets mean that during financial crises these assets may only be sold with high haircuts, resulting in high charges on banks' capital buffers and serious erosion of their capital. Thus, to avoid excessive losses and/or postpone the recognition of losses, banks are likely to maintain the NPLs on their balance sheets. Delayed recognition of NPLs may lead banks to practise 'evergreening',[5] with negative repercussions on efficiency and stability.[6] Therefore, policymakers and bank management need to identify ways of managing NPLs more efficiently so as to reduce the risk of deep haircuts.

The advantages and disadvantages of publicly supported AMCs, as summarised in **Figure 1**, are discussed in more detail in the remainder of this chapter.

[5] This is the practice of not paying the principle of loans for a longer period of time, also known as revolving loans. Banks engaging in evergreening practices do not write down defaulted loans and essentially keep alive "zombie" debtors.

[6] Viral V. Acharya, Lea Borchert, Maximilian Jager and Sascha Steffen, 'Kicking the Can Down the Road: Government Interventions in the European Banking Sector' (2020) NBER Working Papers 27537.

Figure 1: Strengths, weaknesses, opportunities and threats of publicly backed AMCs

STRENGTHS

- Increase in economies of scale
- Strengthening of bargaining power
- Pooling of expertise
- Increase in recovery value
- Reduced funding costs

WEAKNESSES

- Loss of information about the debtor
- Potential prolongation of the life of the AMC to maintain employment

OPPORTUNITIES

- Remove bad assets from bank balances to boost credit growth and realign incentives
- Overcome unwillingness from banks to sell/transfer NPLs
- Bridge the intertemporal valuation gap
- Contribute to financial stability
- Reduce costs to the taxpayers (deposit guarantee scheme (DGS), resolution funds and government contributions)
- Enhance debtor coordination
- Contribute to the development of secondary market for NPLs

THREATS

- Preferential treatment of certain borrowers because of inappropriate asset purchases (political interference)
- Risks becoming an indefinite warehouse of NPLs
- Weakened credit discipline
- Possible fire sale prices disrupting the economy
- Social distress caused by foreclosures
- Transfer of losses from banking system to taxpayers

Source: Authors' composition.

2.1. Advantages

AMCs using public or bank private funds to remove bad assets from bank books[7] seem a superior method of tackling accumulations of NPLs compared with decentralised management of distressed loans at the level of individual banks. Centralisation of NPL management via AMCs has various advantages. First, the deal making process is more clear-cut. Solving the creditors' coordination problem allows for the building of relationships over multiple transactions and can spur secondary markets – enhancing their liquidity – to curb haircuts. Second, AMCs follow a clear mandate to acquire and then dispose of NPLs, thus tackling any unwillingness to sell. Third, AMCs are more efficient because of their ability to focus on single asset classes (with homogeneous assets) and by deploying expertise specific to distressed debt management and workouts, whereas banks lack the ability to develop suitable in-house debt restructuring skills.

The academic literature also offers other arguments in favour of using AMCs to deal with the debt overhang problem, to promote financial stability and to restore market confidence. Ayadi et al. advocate the differentiation between systemic and non-systemic events and propose a theoretically backed

[7] See Daniela Klingebiel, 'The Use of Asset Management Companies in the Resolution of Banking Crises Cross-Country Experiences' (2000) Policy Research Working Paper No. 2284; and Charles W Calomiris, Daniela Klingebiel and Luc Laeven, 'Seven Ways to Deal with a Financial Crisis: Cross Country Experience and Policy Implications' (2012) 24 Journal of Applied Corporate Finance 8.

argument for a centralised Eurozone level approach to maintain fair recovery rates to deal with banks' NPLs.[8]

Enria et al. emphasised the importance of having the infrastructure in place to deal with the legacy assets, whether it is a European AMC or a coordinated plan for national governments to act promptly.[9]

Cerruti and Neyens identify the potential benefits of public AMCs from a large international sample of countries.[10] An AMC could: i) force banks to recognise losses, thereby contributing to rapid restoration of confidence in the financial system; ii) improve asset quality and liquidity (if bonds can be used for collateral at central bank) and provide income to banks; iii) strengthen the financial system (through the exit of non-viable banks and the restructuring of viable banks); iv) enjoy economies of scale and bargaining power, which may contribute to more efficient asset sale and recovery process; and v) allow banks to focus on financial intermediation rather than asset recovery. Using data about NPL policies from over 190 countries over a period of 27 years, Balgova et al. find that a combination of AMCs and public funds made available for recapitalisation is a more effective way to resolve NPLs.[11]

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[8] Rym Ayadi, Giovanni Ferri and Rosa M. Lastra, 'Systemic solutions to systemic crises, dealing with NPLs in the Eurozone' (2017) 1 European Economy – Banks, Regulation, and the Real Sector 173.

[9] Andrea Enria, Piers Haben and Mario Quagliariello, 'Completing the Repair of the EU Banking Sector- A Critical Review of an EU Asset Management Company' (2017) 1 Banks, Regulation, and the Real Sector 59.

[10] Caroline Cerruti and Ruth Neyens, 'Public asset management companies: a toolkit' (2016) World Bank Studies, openknowledge.worldbank.org/handle/10986/24332.

[11] Maria Balgova, Alexander Plekhanov and Marta Skrzypinska, 'Reducing non-performing loans: Stylized facts and economic impact' (2017) American

Similarly, Arner, Avgouleas and Gibson conduct a historical analysis of AMC performance in the aftermath of the Asian financial crisis until the Eurozone debt crisis.[12] They show that even government-backed AMCs proved a better way to restore banking sector stability and national economy than internal loan restructurings accompanied by bank closures and bank mergers. In the jurisdictions they examine, including Indonesia, South Korea and Thailand, AMCs helped the banking sector to tackle NPLs and restore profitability without serious long-term losses accruing to the respective state budgets.

Gaffeo and Mazzocchi, in turn, focus on the development of an efficient secondary market for NPLs and conclude that setting up an EU-backed AMC might help.[13] They argue that such a vehicle might be useful in solving just one of the three failures typically affecting the market for NPLs, namely, excessive information asymmetries between buyers and sellers about the quality of the asset. To successfully tackle the other two – market power and collusion – appropriate design of the market is critical.

Finally, concerning the role AMCs have in bank resolution, which is an essential step for recovery, Lehmann remarks that past EU experience has demonstrated the effectiveness of AMCs, particularly when they work with a large part of the

Economic Association 2018 Annual Meeting: Non-Performing Loans: Causes, Effects and Remedies.

[12] Douglas W. Arner, Emilios Avgouleas and Evan Gibson, 'Financial Stability, Resolution of Systemic Banking Crises and COVID-19: Toward an Appropriate Role for Public Support and Bailouts' (2020) University of Hong Kong Faculty of Law Research Paper No. 2020/044

[13] Edoardo Gaffeo and Ronny Mazzocchi '"The price is right": using auction theory to enhance competition in the NPL market, 20 Journal of Banking Regulation 104.

banking sector and are focused on specific loan types.[14] Asset separation in conjunction with an AMC can also be an effective tool for bank resolution, but the difficulties inherent in setting up an AMC and achieving a track record in restructuring should not be underestimated.

2.2. Disadvantages

AMC intervention presents three key weaknesses and potential threats:

- Shifting a loan to the AMC may imply a loss of information on the debtor and block restructuring if it requires additional credit/liquidity to complete a successful turnaround, a problem which may be acute for information-intensive loans such as those to small and medium-sized enterprises (SMEs) and households, including residential mortgages.
- AMCs should not be seen as an indefinite warehouse of NPLs but should have a clear mandate to work out the acquired NPLs in an efficient manner over a predefined timeline.
- The perception that an AMC is set up with a focus to disburse state aid – e.g., by offering overly generous acquisition prices for the transferred NPLs – should be avoided, since that would impair its functioning by raising voices against the scheme on grounds of equity and distribution.

Cerruti and Neyens submit hat AMCs face a number of key challenges: i) undue political interference; ii) preferential

[14] Alexander Lehmann, 'Carving out legacy assets: a successful tool for bank restructuring?' (21 March 2017) Bruegel Policy Contribution No. 2017/9.

treatment of certain borrowers owing to inappropriate asset purchases; iii) failure to dispose of assets in a timely manner or 'warehousing'; iv) changes in mandate 'mission creep' designed to prolong life of institution and maintain employment; v) weakened credit discipline with frequent asset purchases at inflated prices that do not force banks to recognise losses provides little incentive to strengthen credit underwriting; vi) public AMCs can generate significant losses for the taxpayer.[15]

From a macro-prudential perspective, the policies addressing NPL problems after they arise should take account of relevant side effects, such as the short-term effects of asset foreclosure on asset prices or on borrowers' activity, or the impact of NPL disposal on banks' capital and hence on their lending capacity. Relevant externalities range from possible fire sale prices to the economic disruption and social distress to affected borrowers (or their customers, suppliers, workers, etc.) caused by foreclosure, especially if the number of foreclosures is very high

3. Design and organisational structure of AMCs

The effectiveness of AMCs mostly depends on their capital and funding structure as well as the price at which they acquire NPLs from banks. Alongside the previous points, the Council of the European Commission (CEC) specified that the European Blueprint for AMCs should take the following into account.[16]

[15] Cerruti and Neyens (n 10).
[16] Council of the EC, *Report of the FSC Subgroup on non-performing loans, General Secretariat of the Council* (31 May 2017) 9854/17.

- **Asset mix**. While AMCs enjoy economies of scale through centralised management of NPLs, some NPL classes may be improper and a heterogeneous NPL mix can impair the process. The AMC's mandate should help **identify the most suitable mix of NPLs**.
- **Transfer pricing**. While one of the reasons for setting up the AMC is to raise NPL market value, appropriate methods to assess the value of NPLs and collateral should be employed to **avoid over-optimistic transfer prices** that would burden the AMC with future losses. The rules of engagement with State aid are crucial at this juncture.
- **Capital and funding structure**. A list of alternatives can be considered for the AMC's capital and funding structure and legal status, which, in the case of state ownership may require consolidation in the public sector. It seems desirable to **elicit fruitful public-private partnerships**.
- **Governance and control**. Its governance should protect the AMC from political intrusion or financial stress, possibly establishing its duration ex ante, allowing the AMC to freely avail itself of the most efficient work-out and loan-enforcement schemes.

AMCs also need to fit within the **legal framework** established for bank crisis management as discussed in the remainder of this chapter.

3.1. Asset mix

Suarez and Sánchez Serrano touch on AMCs when they refer to coordination and collective action problems that emerge in the presence of technological or strategic complementarities between agents' decisions.[17] They are **conceptually related to externalities and increasing returns to scale**. In the absence of a coordinating institution, **agents acting in an uncoordinated manner in their own best interests may become trapped into inefficient resource allocation decisions**. For example, if creating a secondary market for NPLs requires set-up costs that can only be recovered if the volume of NPLs is sufficiently large, the economy may be trapped in a situation in which such a market never gets started because it is always too small for the individual agents deciding at the margin whether to establish it. This problem could be solved by promoting the creation of an AMC specialised in buying and managing NPLs.

As preconditions for public AMCs, Cerruti and Neyens list: i) systemic crisis and public funds at risk; ii) critical mass and **homogeneity of NPLs** (when purchasing assets); iii) tradition of institutional independence and public accountability; and iv) a **robust legal framework for bank resolution, debt recovery and creditor rights**.[18]

Peresa and Medina Cas study the experience of three EU AMCs – NAMA, Sareb and FMS Wertmanagement – finding that the type of assets transferred, and the macroeconomic environment, are crucially important for successful asset disposals, and that additional success factors are: i) clean **asset documentation**; ii)

[17] Javier Suarez and Antonio Sánchez Serrano, 'Approaching non-performing loans from a macroprudential angle' (2018) Reports of the Advisory Scientific Committee, No. 7.
[18] Cerruti and Neyens (n 10).

a solid **valuation process**; iii) **efficient asset servicing**; iv) a **strong legal framework**; and v) **skilled staff**.[19]

3.2. Transfer pricing

The price at which banks sell their NPLs (transfer price) is a **key element to consider in the design of AMCs**. Should the transfer price be higher than the book value, banks would not be negatively affected, but AMCs would likely end up suffering losses (or lower gains) once these assets have been disposed of. Loss-making AMCs, after having eroded their equity, might have to be liquidated in the context of insolvency proceedings in the jurisdiction where they have been established, thereby leading to those fire sales that they were meant to avoid in the first place or causing additional losses for the guarantors (mostly governments).

Also, if the transfer price is too high, AMCs cannot break even. If it is too low, banks need recapitalising. So, the guiding principles should be a transparent, market-based, due diligence process conducted by an independent third party experienced in valuation. The legal framework is using as a proxy the EU 'real economic value'[20] which is tied to estimates of long-term economic value of the assets, on the basis of underlying cash flows and a broader time horizon. It is a very loosely defined proxy that can hardly be used for the transfer of assets with

[19] Stephanie M. Cas and Irena Peresa, 'What makes a good 'bad bank'? The Irish, Spanish and German experience' (2016) European Commission Discussion Paper 36.

[20] EC, 'Communication from the Commission on the treatment of impaired assets in the Community banking sector' ('Impaired Assets Communication') (2009) OJ C 72/1, paras 40-42 and Annex IV.

uncertain cash flows or market value.[21] Thus, there is a need for further expert work to clarify this and mandate the use of benchmarks as proxies of value concretising the concept of real economic value.

The transfer price is also instrumental in ascertaining whether NPL transfers comply with the State aid regime.[22] If a publicly supported AMC[23] buys NPLs at a price exceeding the estimated market value, then the transaction involves State aid, whose amount will be the difference between the transfer price and the

[21] See for the methodology used by the Commission the following decisions: (i) Commission Decision on Additional aid for Fortis Banque, Fortis Banque Luxembourg and Fortis holding (12 May 2009), in cases NN 255/2009 (Belgium) and N274/2009 (Luxembourg) (31 July 2009) OJ C 178/2009; (ii) Commission Decision on Illiquid assets back-up facility for ING (31 March 2009), in case C10/2009 (The Netherlands) (11 July 2009) OJ C 158/2009; (iii) Commission Decision on Aid measures provided to LBBW (30 June 2009), in case C17/ 2009 (Germany) (16 October 2009) OJ C 248/2009; (iv) Commission Decision on Establishment of a National Asset Management Agency (NAMA): Asset relief scheme for banks in Ireland (26 February 2009), in case N725/ 2009 (Ireland) (14 April 2010) OJ C 94/2010; (v) Commission Decision on Restructuring of Royal Bank of Scotland following its recapitalisation by the State and its participation in the Asset Protection Scheme (14 December 2009), in cases N422/2009 and N621/2009 (United Kingdom) (07 May 2010) OJ C 119/2010.

[22] See EC (n 20); EC, 'Commission Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules' ('Restructuring Communication') (2009) OJ C 195/9; EC, 'Communication from the Commission on the application, from 1 January 2011, of State aid rules to support measures in favour of banks in the context of the financial crisis' (2010) OJ C 329; EC, 'Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of banks in the context of the financial crisis' (2011) OJ C 356/7; EC, 'Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis' ('Banking Communication') (2013) OJ C 216/1.

[23] See EC, AMC Blueprint (n 4) 4-9.

estimated market value.[24] If that is the case, the transaction needs to be approved by the Commission. For such authorisation to be released, according to the Commission Impaired Asset Communication 2009, the following conditions have to be met:

- the transfer price does not exceed the real economic value;[25]
- losses resulting from the write-down of NPLs from their net book value to the transfer price are not covered by the impaired asset aid; and,
- the valuation of impaired assets is performed by independent experts and validated by the competent authority based on the valuation provisions set out in the Communication.[26]

In addition to these conditions, the requirements for the provision of restructuring aid, according to the Commission's Banking Communication of 2013[27] and the Restructuring Communication of 2009,[28] have to be met as well. These are:

[24] ibid 9.

[25] The concept of real economic value was introduced by the EC, Impaired Assets Communication (n 20) where it is defined as the '*underlying long-term economic value of the assets, on the basis of underlying cash flows and broader time horizon'*. See also ibid 50, stating that the real economic value '*is an estimation of the asset value by disregarding the additional haircuts which private investors require because of the lack of information and because of the temporary illiquidity of those assets. If markets are efficient and liquid, the real economic value of assets equals the assets' market price. However, if markets are seized up by lack of information and illiquidity, the real economic value usually exceeds the (estimated) market price.*'

[26] See EC (n 20).

[27] EC, Banking Communication (n 22).

[28] EC, Restructuring Communication (n 22).

- restoring the bank's long-term viability;
- limiting State aid to the minimum necessary through burden sharing and own contribution; and,
- limiting distortions of competition.

Depending on the price (and conditions) at which a publicly supported AMC purchases NPLs from credit institutions, different scenarios can occur, some of them being fully or partially outside the scope of the State aid and the BRRD[29]-SRMR[30] regimes, and some of them actually triggering the application of such regimes. Thus, purchases of NPLs can take place:

- **Without State aid**. If a publicly supported AMC buys NPLs from a credit institution at the prevailing market price for the requisite assets, by acting as a mere market-based buyer, it does not provide any State aid and therefore the transaction is outside the scope of the State aid and BRRD-SRMR regimes.

[29] Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) no 1093/2010 and (EU) no 648/2012 ('BRRD') [2014] OJ L 173/190. Bank management's and regulators' likely unwillingness to avoid triggering the BRRD has been explained in Emilios Avgouleas and Charles Goodhart, 'Bank Resolution 10 Years From The Global Financial Crisis: A Systematic Reappraisal' in Douglas W. Arner, Emilios Avgouleas, Danny Busch, and Steven L. Schwarcz (eds), *Systemic Risk in the Financial Sector: Ten Years After the Global Financial Crisis* (McGill University Press/CIGI Press 2019).

[30] Regulation (EU) No 806/2014 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 and amending Regulation (EU) No 1093/2010 [2014] OJ L 225/1.

- **Through an asset separation tool in resolution.** When a failing or likely to fail (FOLF)[31] credit institution has been submitted to resolution, the resolution authority can apply the 'asset separation tool', which is in essence an AMC buying some of the assets of the institution under resolution.[32] In this context, additional support might be needed in order for the transaction(s) to take place. Accordingly, financial means (qualified as State aid) can be provided either by the Single Resolution Fund (SRM) or by the national resolution fund. Such support can be given when it is considered necessary for the efficient application of resolution tools, yet a number of strict conditions need to be met.[33]
- **With State aid in the context of national insolvency proceedings.** When a FOLF credit institution has entered into insolvency proceedings under national law, the national authority in charge of handling the crisis might opt for the transfer of NPLs to an AMC. Public support might be needed to enable the AMC to buy NPLs. Against this background, the Banking Communication 2013 allows Member States, under certain conditions, to provide liquidation aid to facilitate the exit of non-viable institutions in an orderly

[31] BRRD, Article 32 para 4.

[32] The asset separation tool is provided pursuant to Article 42 of the BRRD.

[33] The use of the Single Resolution Fund (SRF) is subject to State aid rules and thus requires authorisation from the Commission. The provision of such support also requires a minimum contribution to loss absorption and recapitalisation of 8% of total liabilities including own funds by shareholders and creditors of the entity in resolution, if losses are indirectly passed on to the SRF. In that case, the upper limit for contributions by the Fund is capped at 5% of the total liabilities including own funds of the entity under resolution.

manner in order to avoid negative effects on financial stability.[34] Such conditions are: limitation of liquidation costs, limitation of competition distortions and burden sharing.[35]

- **With State aid through a precautionary recapitalisation.** A solvent and non-FOLF credit institution can benefit from State aid without being consequently determined as FOLF, when the aid is granted in the context of a 'precautionary recapitalisation' and the ensuing requirements are met.[36] Such a tool has been mostly adopted to increase

[34] On liquidation aid see EC, Banking Communication (n 22) paras 65 et. seq.; in this regard see also Rosa M. Lastra, Constanza A. Russo and Marco Bodellini, 'Stock Take of the SRB's activities over the past years: What to Improve and Focus On?' (2019) Policy Paper Drafted for the European Parliament, europarl.europa.eu/RegData/etudes/STUD/2019/634392/IPOL_STU(2019)634392_EN.pdf.

[35] Additionally, the transfer of NPLs from a credit institution to a publicly supported AMC is also to be assessed under the EC, Impaired Assets Communication (n 3). In this regard, the complete liquidation of the institution under ordinary insolvency proceedings does not require the transfer price of the NPLs to be below the loans' real economic value, as the residual entity will be facing constraints that limit distortions of competition and will totally exit from the market; on the provision of liquidation aid in the crises of Banca Popolare di Vicenza and Veneto Banca, see Marco Bodellini, 'To bail-in, or to bail-out, that is the question' (2018) 19 European Business Organization Law Review 365.

[36] A number of conditions have to be met for implementing a precautionary recapitalisation: 1) it can take place in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability; 2) it must be confined to solvent institutions that are not FOLF; 3) is of a precautionary and temporary nature; 4) is conditional on final approval under the EU State aid framework; 5) must be proportionate to remedy the consequences of the serious disturbance of the economy; 6) should not be used to offset losses that the institution has incurred or is likely to incur in the near future; 7) should be limited to injections necessary to address capital shortfall established in national, EU-wide or SSM-wide stress tests, AQR reviews or equivalent

> the capital of solvent institutions that have failed a stress test in the so-called adverse scenario.[37] Yet it could also be used to enable the transfer of NPLs to a publicly supported AMC, provided that the intervention pursues the same objective as capital injection and the specific State aid conditions for impaired asset measures are respected.[38] This implies that impaired assets can be purchased by the AMC at a transfer price that exceeds the estimated market value of the NPLs but which does not exceed their real economic value.

The result of NPL purchases in the context of a precautionary recapitalisation might indeed be equivalent to a capital increase. This begs the question whether precautionary recapitalisation could be used alongside an AMC solution. As one of the main tasks of using an AMC to tackle NPLs is to achieve a clean break by crystallising NPL losses, it is unlikely that precautionary recapitalisation can follow the establishment of an AMC. Indeed, precautionary recapitalisation cannot be used to offset incurred losses. By contrast, the establishment of an AMC could follow precautionary recapitalisation to speed up the post-recapitalisation cleaning of the bank NPLs but in this case without the AMC enjoying any public backstop. It follows that the two solutions are not mutually exclusive, but a decision must have been taken in advance that the AMC will follow

exercises conducted by the ECB, the European Banking Authority (EBA) or national authorities, where applicable, confirmed by the competent authority.

[37] See Marco Bodellini, 'Greek and Italian 'Lessons' on Bank Restructuring: Is Precautionary Recapitalisation the Way Forward?' (2017) 19 Cambridge Yearbook of European Legal Studies 144-164.

[38] See EC, AMC Blueprint (n 4) 8.

rather than precede the recapitalisation and will not receive any public subsidies.

3.3. Capital and funding structure

The effectiveness of AMCs critically depends on their capital and funding structure. Although AMCs should be (at least partially) owned by the transferring banks to reduce moral hazard, they can still be either privately or publicly funded.[39] Yet according to previous experience across the globe it seems that some sort of public support has often been a key element in their success.[40] In the EU, nevertheless, this needs to reconcile with the State aid regime.

According to Cerruti and Neyens adequate and timely funding and lifespan provide time to realise value of assets **(avoiding 'fire sales') but prevent permanent warehousing of bad loans**.[41]

Santos analyses the capital structure of private asset managers in which the acquisition of NPLs is funded with Contingent Convertibles (CoCos) placed with investors.[42] The paper develops a model based on NPL transfer prices and residual recovery rates to assess capital structures consisting of CoCos and equity. The CoCos would contain put and call options to

[39] Publicly funded AMCs typically issue senior unsecured bonds, which are bought by those banks that intend to transfer their NPLs to the AMCs. Such senior bonds usually carry a full and irrevocable guarantee of the national Treasury and would thus be eligible as collateral in refinancing transactions with the central bank. They often have a call option available to the issuer as well.

[40] See Arner et al. (n 12).

[41] Cerruti and Neyens (n 10).

[42] André O. Santos and Alfreo Cuevas, 'Can Contingent Convertibles Help Private Asset Managers Fund Their Acquisition of Non-Performing Loans from Portuguese Banks?' 99 IMF Working Papers 2017.

write down losses and write up profits respectively that arise from liquidation and restructuring procedures to **bridge the gap between NPL bid prices and private equity firms' ask prices**.

Public funding is not *per se* classified as State aid. The determining factor is what a private sector operator would do in the same situation. In other words, public funding would not be considered as State aid if a private sector operator would act in a similar way in an equivalent situation. For this to occur, the purchase of NPLs should take place at the market price (or at the estimated market value[43] when the former is not available) and the other conditions laid down in the European Commission's Crisis Communications need to be met as well.

At any rate, the Commission has already made it clear that '*[t]he option of an AMC involving State aid should not be seen as the default solution since AMCs can take multiple forms and can be structured and financed in several ways*'[44] and that the use of AMCs should not prevent FOLF banks '*from being liquidated or resolved under the BRRD, which provides for an efficient framework enabling market exit of troubled banks while minimising costs to the taxpayer and negative repercussions to the economy.*'[45]

3.4. Governance and control

The governance and control mechanism should protect the AMC political intrusion or financial stress. Cerruti and Neyens also find that successful AMCs have strong commercial

[43] See EC, AMC Blueprint (n 4) 50.
[44] See EC, Communication tackling NPLs (n 3) 11.
[45] See EC, AMC Blueprint (n 4) 23-24.

focus.[46] First, AMCs should have professional distressed asset management, strong governance practices, **robust transparency requirements, and strong internal controls**: independent boards with strong private sector/international presence; documentation of key decisions; internal staff rules and codes of conduct; **key performance indicators** (KPIs); and periodic progress evaluations conducted by **external auditor**. Second, AMCs need strategic and operating plans aligned with mandate: asset purchases have clear rationale, and all assets have well-defined resolution plans and exit strategies; **social mandates which conflict with commercial focus were minimised**.

3.5. Legal framework

There are a number of legal obstacles potentially hindering the successful establishment of AMCs in the EU or of a pan-European network of AMCs. In this regard, one of the most critical issues relates to the State aid regime.[47] Direct or indirect involvement of the state(s) in the funding of AMCs could trigger, depending on the transfer price, State aid restrictions. By contrast, if selling NPLs to AMCs means that bank losses materialise, there is always the possibility that they will exhaust their capital buffers, triggering the application of the EU bank-resolution regime. The application of this regime can lead to a

[46] Cerruti and Neyens (n 10).

[47] Article 107 TFEU provides that any State aid is incompatible with the internal market, unless it qualifies as one of the narrow exceptions set out in Article 107(2) TFEU or unless it has been approved by the Commission for one of the reasons set out in Article 107(3) TFEU. In relation to public support given to banks, the reason mostly adopted so far to authorise the aid has been, according to Article 107(3)(b) TFEU, '… to remedy a serious disturbance in the economy of a Member State'.

number of actions taken by the SRB and/or national resolution authorities, including the bailing-in of bank creditors and liquidation.[48] The AMCs' funding structure and the price at which they buy NPLs from credit institutions are thus critical aspects to carefully consider to avoid triggering the State aid regime, which in turn could determine the application of the resolution (or liquidation) regime as well. Indeed, the resolution (or liquidation) framework under the BRRD-SRMR provides that a bank requiring extraordinary public financial support is to be declared as FOLF, unless the conditions for precautionary recapitalisation are met.[49] The FOLF declaration triggers the initiation of either resolution or liquidation, depending on what is in the public interest.

4. Comparison of national AMCs

Several public AMCs were set up in the EU in the years following the 2007-09 global financial crisis and the 2010-12 euro sovereign debt crisis. These AMCs acquired, managed, and disposed of distressed assets, and played an important role in bank restructuring.[50]

While all AMCs must be fully compliant with the EU legal framework, there are substantial differences in the design and organisational structure of these entities, as well as in the role

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[48] In the post-global financial crisis EU legal framework, resolution and liquidation are the two alternative procedures to initiate in the face of a FOLF bank, depending on what is in the public interest; see Marco Bodellini, 'Alternative forms of deposit insurance and the quest for European harmonized deposit guarantee scheme-centred special administrative regimes to handle troubled banks' (2020) 25 The Uniform Law Review, 212, *passim*.
[49] The relevant provisions as to precautionary recapitalisation are article 18(4)(d)(iii) of the SRMR and article 32(4)(d)(iii) of the BRRD.
[50] Annex 1 provides an overview of these entities, including the year of establishment and the EU member state.

governments and restructuring authorities have played in different member states.

In what follows, we will present an analysis of selected European AMCs, with the aim of comparing these entities along several lines to discuss the strengths and weaknesses of the different models.

4.1. Capital and funding structure

AMC asset acquisition can be funded in a number of ways: (i) through the issuance of debt securities with or without government guarantees; (ii) through direct capitalisation by governments; (iii) though private investors' equity and loss sharing; and (iv) through a combination of public and private equity, guarantees and private loss sharing. As a result, the landscape of AMCs is varied across EU Member States, with the full spectrum of ownership structures and many organisational design choices.

Importantly, organisational designs and ownership structures affect how AMCs impact on public budgets. Gandrud and Hallerberg identify three stages in the creation of European AMCs (see **Table 1**): (1) before 2009, a phase characterised by a variety of AMC ownership types; (2) 2009-2014, when governments tended to create AMCs with a minimal majority share (51 %) of private ownership; and (3) post-2014, where bailed-in shareholders of failed banks own the AMCs created to resolve them.[51]

[51] Christopher Gandrud and Mark Hallerberg, 'Statistical agencies and responses to financial crises: Eurostat, bad banks, and the ESM' (2016) 39 West European Politics 545.

Table 1: Phases of AMC creation in Europe

Phase	Time period	Type of ownership	Examples: Restructuring of privately owned banks	Examples: Restructuring of publicly owned banks
1	Pre-2009	Mixed, including majority public ownership	Finansiel Stabilitet (DK), RPI (BE), Société de Financement de l'Economie Française (FR)	Erste Abwicklungsanstalt (DE), FMS Wertmanagement (DE)
2	Mid-2009 to mid-2014	Slim private majority ownership	NAMA SPV (IE), SAREB (ES)	Dexia (BE/FR/LU), DUTB (SI), Parvalorem/Parups/ Parparticipadas (PT), KA Finanz (AT), Propertize (NL), UK Asset Resolution (UK)
3	Mid-2014 onwards	Large majority private ownership	Banco Espírito Santo (PT)	HETA Asset Resolution (AT)

Source: Authors' elaboration of Grandud & Hallerberg (n 51).

4.2. Ownership structure

Perhaps the best way to understand the differences between the AMCs that have been set up since the Global Financial Crisis is to consider the role of the government. The earliest AMCs were strictly internal bank restructuring units, set up as a separate division or subsidiary of the troubled banks and focused on the wind-down of ring-fenced portfolios of bad or non-strategic assets. More recently, these AMCs have been receiving help from their respective governments. Examples include Erste Abwicklungsanstalt (EAA), the bad bank of WestLB, and FMS Wertmanagement (FMS/WM), and the bad bank of Hypo Real Estate Holding AG (HRE), both in Germany.

The creation of AMCs with 100% public ownership has been a common feature of restructuring activities started as a consequence of the global financial crisis (see **Table 2**). Examples of 100 % national government ownership are FMS/WM (Germany) and Družba za upravljanje terjatev bank, dd (DUBT) (Slovenia), while AMCO, established after the euro sovereign crisis, is owned by the Italian Ministry of Finance. A minority public ownership was chosen by the Irish authorities, whereby the NAMA owns 49 %, and 51 % of shares are collectively owned by private companies via the establishment of the NAMA Investment DAC. Similarly, SAREB was set up as a private company. The Fund for Orderly Bank Restructuring (FROB) owns 45 % while private shareholders own the remaining 55 % of SAREB. The initial private shareholders were mostly Spanish banks, two foreign banks: Deutsche Bank and Barclays Bank, and four insurers. Other banks and insurance companies have subsequently participated.

Table 2: Selected European AMCs – ownership structure

AMC	Country	Main shareholder	Share of public ownership	Other shareholders	Notes
AA1/EAA	Germany	Regional government (State of NRW, 48.202 %)	100 %	Savings Banks; Regional authorities	Rheinischer Sparkassen- und Giroverband (25.032 %) Sparkassenverband Westfalen-Lippe (25.032 %), Landschaftsverband Rheinland (0.867 %) Landschaftsverband Westfalen-Lippe (0.867 %)
FMS/WM	Germany	National government (SoFFin)	100 %		
NAMA	Ireland	National government (National Asset Management Agency Investment)	49 %	51 % (National Asset Management Agency Investment DAC.)	51 % of its shares are collectively owned by private companies (New Ireland Assurance Co. plc, BNY Custodial Nominees (Ireland) Ltd, the Representative Church Body and the Church of Ireland Clergy Pensions Fund)
AMCO	Italy	Italian Ministry	99.78 %	0.22 % Other	Other shareholders

AMC	Country	Main shareholder	Share of public ownership	Other shareholders	Notes
		of Finance (MEF)		shareholders	have B shares with no voting rights
DUTB	Slovenia	National government (ZUKSB)	100 %		
SAREB	Spain	FROB (Spanish National Resolution Authority) / National government	45.95 %	Banks, other investors (54.05 %)	Banco de Sabadell (6.61 %), Caixabank, S.A. (12.24 %), Banco Santander, S.A. (22.22 %) and Others (13.03 %)

Source: Authors' elaboration based on AMC websites and annual reports (2019).

4.3. NPL perimeter, size and mix

AMCs also vary substantially in terms of size. The largest one is FMS/WM, with a nominal value of assets of around EUR 175.700 million initially transferred. This was established in 2010 with the aim of taking over and winding up the risk positions and non-strategic operations from the nationalised HRE Group. In 2014, FMS Wertmanagement (FMS/WM) was commissioned to take over and wind up the former Irish subsidiary of the HRE Group, Deutsche Pfandbriefbank plc (DEPFA). FMS/WM acquired assets from the DEPFA Group in 2016 and 2017, with an original nominal value of around EUR 7.200 million, therefore expanding its portfolio. Since then, FMS/WM has made good progress in winding down its portfolio and has remained profitable since its inception (see **Table 3**).

While some AMCs are set up with the limited mission of unwinding the portfolio of a particularly troubled bank, others are successively entrusted with assets from different institutions. In some cases, restructuring help extends to a particular category of banks, for example the Spanish saving banks.

Table 3: Selected European AMCs – size and portfolio

AMC	Portfolio	Perimeter	Nominal value of asset transferred (EUR million)	Market value of assets transferred (EUR million)	Total assets - 2019 (EUR million)	Equity - 2019 (EUR million)	Employees - 2019
AA1/ EAA	WestLB	Structured assets	77 500	na	37 815	655	159
FMS/ WM	Hypo Real Estate Holding AG, DEPFA BANK plc	All asset types	357 800 * (resolvable assets: 175 700)	na	146 490	1 751	103
NAMA	AIB, Bank of Ireland, Anglo Irish Bank, EBS, Irish Nationwid	CRE, land and property	74 000	26 200	5 612	5 569	211

AMC	Portfolio	Perimeter	Nominal value of asset transferred (EUR million)	Market value of assets transferred (EUR million)	Total assets - 2019 (EUR million)	Equity - 2019 (EUR million)	Employees - 2019
	e Building Society						
AMCO	Veneto Banca and Banca Popolare di Vicenza Banca Carige	Non-performing loans (NPLs)	18 000	na	2 755	600	220
DUTB	NLB and NKBM Abanka, Banka Celje Probanka, Factor banka.	Non-performing loans (NPLs) and developer loans	5 800	2 020	824	484	135
SAREB	BFA-Bankia, Catalunya Banc, Banco de Valencia, Novagalicia Banco and Banco Gallego Liberbank, Caja 3,	Developer loans and real estate assets	50 781	107 000	31 470	230	394

AMC	Portfolio	Perimeter	Nominal value of asset transferred (EUR million)	Market value of assets transferred (EUR million)	Total assets - 2019 (EUR million)	Equity - 2019 (EUR million)	Employees - 2019
	CEISS and BMN						

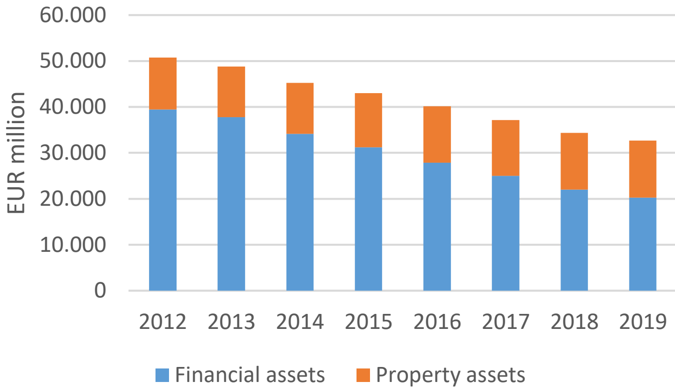
Note: * The total assets of FMS/WM also included a large portfolio of debt issued by HRE Group with a government guarantee from SoFFin, which were by own issuances of FMS /WM.

Source: Authors' elaboration based on AMC websites and annual reports (2019).

4.4. Mandate and lifespan

The mandate and lifespan are important characteristics of AMCs and we can observe substantial differences. Some AMCs explicitly state in their mission the number of years over which they are to liquidate the assets. For example, SAREB states that its mission is the orderly liquidation of assets over a 15-year period, ending in November 2027. At the end of 2019, SAREB's financial asset portfolio had decreased 51 % while the overall portfolio had reduced 36 % (see **Figure 2**).

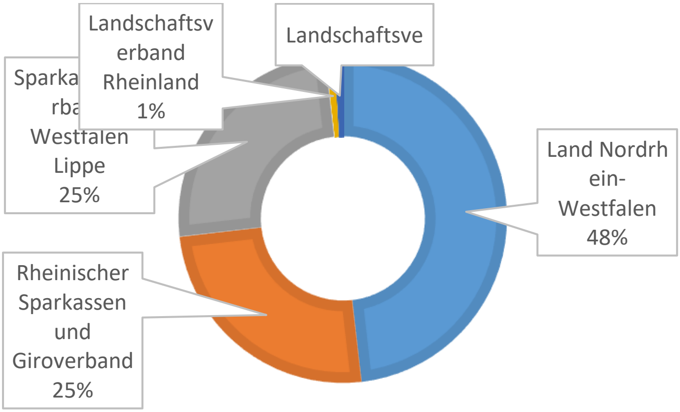
Figure 2: Changes in SAREB's portfolio (2012-2019)



Source: Authors' elaboration based on annual reports SAREB.

Similarly, AA1/EEA has a clearly defined public function, which is to take over and wind up the WestLB's risk exposures and non-strategic businesses and assets, in a manner that minimises risk over a 15-year period. The EAA enjoys a high credit rating from the main credit-rating agencies, as it benefits from an extremely high likelihood of support from its public owners, primarily the German regional State of North Rhine-Westphalia (NRW), the regional savings banks associations of Westphalia-Lippe and Rhineland (25 % each) and the local public authorities of Westphalia-Lippe and Rhineland (0.9 % each) (see **Figure 3**). So far, the EAA has wound up more than four fifths of the transferred positions. And while doing so, it has been profitable since 2012 (see **Table 4**).

Figure 2: Changes in SAREB's portfolio (2012-2019)



Source: Authors' elaboration based on annual reports AA1 (2019).

Other AMCs have a longer history. The Italian AMCO was originally established in 1989, and in 1996 it launched the operations related to the rescue of Banco di Napoli (BdN). The current structure was set up in 2016, to allow for the acquisition and/or management of loans other than those of the BdN. In 2018, it took over the management of Veneto Banca (EUR 7.7 billion) and Banca Popolare di Vicenza (EUR 4.3 billion) portfolios. It also acquired EUR 2.3 billion of NLPs from Banca Carige, among others. At the end of 2019 AMCO had a total asset size of EUR 2.8 billion.

4.5. Performance

Evaluating the performance of AMCs is not a straightforward task, and the diversity of mandates, objectives, lifespan, transfer prices, and ownership structures could distort the application of traditional benchmarks for operational performance.

One standard measure of performance is the evaluation of net profit/loss. AMCs generate revenue from the management and sale of loans, and from the sale and letting of exploitable assets such as real estate. Other revenues include revenues from financial assets. Costs include operating costs, costs of recoveries, interest expenses, staff costs and provisions. Most AMCs have been profitable in recent years, with the exception of SAREB (see **Table 4**).

Table 4: Selected European AMCs – net profit/losses (EUR million)

AMC	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Total
AA1/EAA	-599.6	-878.2	6.6	59.0	62.5	13.1	9.6	14.4	2.6	-2.7	-1 312.7
FMS/WM	-2.0	0.0	36.8	122.0	313.4	295.9	313.3	359.1	114.8	236.1	1 789.4
NAMA	-1 180.0	246.6	232.0	213.6	458.3	1 825.9	1 502.7	480.8	794.6	264.9	4 839.4
AMCO	..	..	..	..	..	..	13.1	1.9	47.5	39.9	102.4
DUTB	..	..	..	-5.8	36.4	-8.3	7.8	67.0	57.6	40.2	194.9
SAREB	..	..	-7.8	-402.9	-1 000.6	-135.2	-662.7	-533.9	-879.0	-864.3	-4 486.4

Source: Authors' elaboration based on annual reports of AMCs.

5. Concluding remarks and policy lessons

The COVID-19 pandemic is likely to cause NPL stock to increase sharply, prices to be further depressed and borrowers/consumers to suffer hardship over the next few years.

Buyers are unlikely to be willing to pay a price reflecting the real economic value of such assets, possibly also taking advantage of the new rules requiring credit institutions to progressively increase loss provisioning under Regulation 2019/630/EU.[52] Moreover, defaulted borrowers and consumers will be further subjected to difficulties in the absence of harmonised rules that deal with detriment inflicted during the debt-collection exercise. At the same time, several legal shortcomings and structural obstacles might hinder the ability of AMCs to perform.

The use of publicly supported national, Pan-European AMCs or network(s) of publicly supported national AMCs can overcome the aforementioned market failures in NPL resolution and their broader consequences on the economy and society. But to achieve this objective AMCs must operate under robust management and governance frameworks. In addition, the skills of AMC staff are essential to the achievement of this objective and are a key determinant of the company's performance.

AMC performance must be evaluated more broadly and not only against financial benchmarks (e.g., efficient wind-down of NPLs). Their wider economic (e.g., preservation of financial stability) and social role (e.g., reduction of consumer detriment and hardship inflicted by the widespread financial and

[52] Regulation (EU) 2019/630 of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures [2019] OJ L 111/4.

economic crises) must also be evaluated. In the same context the possibility of AMC playing a broader turnaround role should not be overlooked.

A certain amount of public support will be needed for AMCs to be able to successfully operate and this also seems to be the view of the Commission.[53] The main issue concerning public support is that every purchase of NPLs carried out by a publicly supported AMC at a price exceeding the estimated market value qualifies as State aid. The qualification of such transactions as State aid in turn would cause the concerned bank(s) to be classed as FOLF, unless the intervention takes place in the form of a precautionary recapitalisation. In other words, the only way for a publicly supported AMC to buy NPLs from banks at a price reflecting their real economic value would currently be through a precautionary recapitalisation.

Despite the Commission's decision after the outbreak of the pandemic to relax the rules on public support and to extend the exception under point 45 of the 2013 Banking Communication, it is questionable whether precautionary recapitalisation would be a suitable tool to handle the widely predicted surge in NPLs affecting many banks in the Union. Precautionary recapitalisation is indeed a measure primarily conceived to face single (or a limited number of) idiosyncratic crises through the injection of public money with a view to increasing the capital of individual banks. Therefore, it might fall short if many institutions needed to offload large portfolios of NPLs at the same time.[54]

[53] See EC, AMC Blueprint (n 4) 15.
[54] The Commission has already stated that if a transfer of NPLs to an AMC is to be (partially) financed with a precautionary recapitalisation, that bank

Several structural obstacles might affect the ability of AMCs to contribute to resolving the NPL issue in the Union. The most relevant obstacles in this regard relate to: i) long recovery times and consequent high costs that also differ from country to country; ii) low and different levels of transparency, which create 'the market for lemons'[55] conditions in the secondary market and increase bid-ask spread discrepancies; iii) appreciable disparities between net book value and market value; iv) low profitability of banks;[56] and v) dealing effectively with consumer detriment issues. It follows that for AMCs to be effective tools, such structural obstacles need to be removed as well. From this perspective, the Commission Action Plan of December 2020 puts forward a number of effective measures that should be implemented as soon as possible.

From a socio-economic perspective, in the process of debt collection, debtors face a range of detriments (financial, psychological, and social) resulting from the strong pressure to repay their debts. These can be costly for the individual debtor as well as for wider society. The AMC should therefore aim to collect the debt, while ensuring that the individuals retain a minimum living wage.[57] Similarly, the longer-term viability of businesses should also be considered in the context of debt collection, so that potential extensions, refinancing and write-offs can maintain jobs and economic activity. Although this

should first participate in a national or EU-wide AQR, stress testing or similar exercise; EC, AMC Blueprint (n 4) 8.

[55] See George A. Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84 The Quarterly Journal of Economics 488.

[56] See Avgouleas and Goodhart (n 1) 99.

[57] See Eurofound, 'Concept and practice of a living wage' (2018) Publications Office of the European Union, eurofound.europa.eu/sites/default/files/ef_publication/field_ef_document/ef18064en.pdf.

approach can have a negative impact on the recovery values and operational efficiency of the AMCs, it is not necessarily the case because this approach also increases the earnings and thus the repayment capacity of both individuals and businesses. To avoid a potential financial loss for the government, the methodology for the real economic value calculation would have to consider the winding down of the NPLs following this approach.

Finally, the Commission would be well advised to rethink the way State aid rules apply in relation to the purchase of NPLs. It might be appropriate to reconsider the treatment of NPL purchases at prices that reflect the real economic value. Although developing a set of criteria and valuation methodology that would make the real economic value a more concrete concept is urgently required, it may not be possible to do so in all cases. Thus, asset purchases at prices reflecting real economic value should not automatically qualify as illegitimate State aid, as, in principle, no financial loss for the government is expected. A Treaty-compliant interpretation could be advanced on grounds of broader public interest. Namely, that in the post-COVID-19 period, public support would be used, not just for the benefit of single banks, but mostly to correct a system-wide market failure affecting the price formation of NPLs. This would be mainly because of the negative macroeconomic juncture caused by the pandemic, along with a number of other factors (i.e., lack of information and illiquidity). It can only be properly tackled over time through a host of measures, such as the ones that the Commission has included in its Action Plan.[58] This argument could be at least

[58] The Treaty legal basis could be either: (i) article 107(2)(b): '*The following shall be compatible with the internal market: (...) aid to make good the*

supported in the case of a pan-European system-wide AMC whose mandate would be to help clean up the banking system from the burden of NPLs generated by the COVID-19 crisis.

damage caused by natural disasters or exceptional occurrences'; or (ii) article 107(3)(b): '*The following may be considered to be compatible with the internal market: (...) aid (...) to remedy a serious disturbance in the economy of a Member State*'.

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6. Banking supervision in times of uncertainty: the case of NPLs

Concetta Brescia Morra

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1. COVID and banking supervision

At the dawn of the pandemic, the Basel Committee,[1] the European Banking Authority (EBA),[2] and the European Central Bank (ECB)[3] produced documents, guidelines, and approved

[1] Basel Committee on Banking Supervision, 'Measures to reflect the impact of COVID-19' Bank for International Settlements (April 2020), bis.org/bcbs/publ/d498.pdf. The Basel Committee agreed that the risk-reducing effects of the various extraordinary support measures, namely government guarantees and different payment moratoriums, taken in its Member jurisdictions, should be fully recognised in risk-based capital requirements.

[2] During the months of March and April 2020, the EBA published several communications calling upon competent authorities to make full use of the flexibility embedded in the existing prudential regulation and to establish guidelines containing a number of interpretative aspects on the functioning of the prudential framework in relation to the classification of loans in default, the identification of forborne exposures, and their accounting treatment.

[3] The ECB played a crucial role in fostering banks' abilities to finance the economy, see ECB, 'ECB Banking Supervision provides temporary capital

amendments to the prudential legal framework for banks to facilitate the granting of credit to the real economy. A first set of resolutions aimed at allowing measures established by national governments to mitigate the negative impact on the economy of the coronavirus to fully achieve this goal. Primarily, national measures included public guarantees on new loans and moratoriums on existing loans for firms in difficulty. A second set of resolutions established temporary capital,

and operational relief in reaction to coronavirus' (Press release, 12 March 2020, bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200312~43351ac3ac.en.html; and ECB, Press release, *ECB Banking Supervision provides further flexibility to banks in reaction to coronavirus* (20 March 2020), bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200320~4cdbbcf466.en.html. The ECB provided a number of specific measures to ensure that banks can continue to fulfil their role in financing the real economy as the economic effects of the coronavirus became apparent. In fact, the ECB has introduced supervisory flexibility regarding the treatment of non-performing loans (NPLs), regarding the classification of debtors as "unlikely to pay" when banks call on public guarantees granted in the COVID-19 pandemic context, and regarding loans under COVID-19-related public moratoriums. Moreover, the ECB adopted specific measures relaxing capital constraints, namely temporary capital, liquidity, and operational relief measures to ensure that significant institutions are able to continue to support the real economy. According to the ECB guidelines, banks benefit from relief in terms of the composition of capital for Pillar 2 requirements. Furthermore, banks are temporarily allowed to operate below the level of capital defined by the Pillar 2 guidance and the capital conservation buffer. One last recommendation to banks from the ECB attempted to balance the need to favour the capacity of banks to finance the real sector on the one hand with the need to preserve the robustness of the bank's capital on the other, see ECB, 'ECB asks banks not to pay dividends until at least October 2020' (Press release, 27 March 2020), bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200327~d4d8f81a53.en.html. The ECB extended its recommendation to banks not to pay dividends until January 2021 in July 2020, see ECB, 'ECB extends recommendation not to pay dividends until January 2021 and clarifies timeline to restore buffers' (Press release, 28 July 2020), bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200728_1~42a74a0b86.en.html.

liquidity, and operational relief measures to banks to boost their capacity to finance the economy. In both cases, it came down to temporary extraordinary measures.

The intervention of the legislator was required in Europe to put in place a significant number of these initiatives. Actually, to implement some measures, decided by the Basel Committee in April 2020, aimed at mitigating the impact on regulatory capital of unexpected events, an amendment to the Capital Requirement Regulation (Reg. 575/2013) was needed. In fact, the European legislature has completed the framework of ‘extraordinary rules’ with a package of reforms amending the Level 1 regulation. On 28 April 2020, the EU Commission proposed a few targeted ‘quick fix’ amendments to the EU’s prudential banking rules (the Capital Requirements Regulation) in order to maximise banks’ abilities to lend and absorb losses related to the COVID-19 pandemic. On 18 June 2020, the European Parliament approved the amendments to Regulation (EU) 575/2013 (Capital Requirement Regulation (CRR)) and Regulation 2019/876 (Capital Requirement Regulation 2 (CRR2)) to mitigate the economic consequences of COVID-19. The new rules establish exceptional temporary measures to alleviate the immediate impact of coronavirus-related developments by adapting the timeline of the application of international accounting standards on banks’ capital, treating public guarantees granted during the crisis more favourably, postponing the date of application of the leverage ratio buffer and modifying the way of excluding certain exposures from the calculation of the leverage ratio.

The response of the European legislator was very rapid given the exceptional nature of the moment, but it is evident that the legislative instrument is not suited for sudden changes. If the consequences of the pandemic were to extend beyond what was foreseen by the 'quick fix package', a political agreement to prolong the measures could be more difficult to reach in the European Parliament.

Differently, during the summer of 2020, the supervisory authorities, considering that it was still highly uncertain how the macroeconomic shock would have affected the banking system, were able to take timely initiatives to face the evolution of the crisis, within the limits of the margins of flexibility allowed by the legal system. Indeed, the supervisory authorities have since prolonged most of the rules that established flexibility in the application of the supervisory rules for a limited period of time. The ECB decided to extend the period of validity of many extraordinary measures.[4] The EBA at first phased out its guidelines on loan repayments moratoriums, but on 2 December 2020, after closely monitoring the developments of the COVID-

[4] ECB, 'ECB extends recommendation not to pay dividends until January 2021 and clarifies timeline to restore buffers' (Press Release, 28 July 2020), bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200728_1~42a74a0b86.en.html (the ECB prolonging the recommendation to refrain from dividend distributions until the end of 2020, announcing that banks would not be required to submit their plans for reducing NPLs until March 2021, and stating that compliance with Pillar 2 Guidance and the combined buffer requirement will not be required any earlier than by the end of 2022). On the latter point, in many press releases the ECB declared that it would not have attached any negative judgment to banks, which are making use of the buffers, in line with a recent recommendation of the Basel Committee on Banking Supervision, 'Basel Committee meets; discusses impact of Covid-19; reiterates guidance on buffers' (Press release, 17 June 2020) bis.org/press/p200617.htm; in particular, see Andrea Enria, 'The coronavirus crisis and ECB Banking Supervision: taking stock and looking ahead' (*The Supervision Blog*, 28 July 2020) (stating that 'banks are encouraged to use their available buffers to absorb losses and continue lending in the real economy without concerns about being potentially stigmatised for using them or needing to quickly replenish them').

19 pandemic and, in particular, the impact of the second COVID-19 wave and the related government restrictions taken in many EU countries, it decided to reactivate those guidelines.

All the measures described above are exceptional and temporary. Considering that the second wave of the pandemic has hit many countries severely, including the main European Member States, it is difficult to forecast what the authorities' exit strategy could be if the situation were to remain complex from a health point of view and give rise to a long-term economic recession. It is also too early to estimate the impact that this crisis could have on the stability of the banking system.

When the immediate effects of the crisis will be overcome, will the extraordinary measures help to establish a new supervisory standard? On this, the ECB has commented that in the medium to long-term, banks should continue to apply sound underwriting standards, pursue adequate policies regarding the recognition and coverage of non-performing exposures, and conduct solid capital and liquidity planning and robust risk management.

This means that extraordinary measures are appropriate for extraordinary times but cannot last long so as not to jeopardise financial stability. Nevertheless, the pandemic has shown that a certain degree of flexibility of the legal framework is needed. A crucial issue is to allow the European authorities wide margins of discretion to adapt prudential rules to crisis situations, in particular to mitigate their pro-cyclical nature.

2. The NPLs issue after the GFC and the COVID-19 crisis: what is new?

At the onset of the global financial crisis (GFC), international and European authorities acknowledged the need for developing a common strategy to deal with the massive sprawling deterioration of financial institutions' principal assets and the unprecedented increase in NPLs in banks' balance sheets. A broad consensus has been reached among European and international authorities that high levels of NPLs can negatively impact the economy both in terms of financial stability and economic growth. The commitment of the European legislator to tackle NPLs has been strengthened in recent years, in particular by addressing this issue in two main directions: on the one hand, by introducing strict prudential and accounting rules aimed at ensuring the financial solvency and transparency of balance-sheets of European credit institutions and, on the other hand, by promoting a package of measures aimed at fostering NPLs secondary markets.[5]

More than ten years after the start of the GFC, accounting and prudential rules have been implemented but measures fostering the NPLs secondary market are still not in place.

One year after the outbreak of the pandemic, the total level of NPLs has not yet increased so as to put financial stability at risk ('in Q2-2020, the average Tier 1 capital ratio for all EU banks amounted to 16.4%, and the average NPL ratio stood at 2.8%. The liquidity coverage ratio for significant financial institutions

[5] Council of the EU, 'Banking: Council sets out action plan for non-performing loans' (Press release, 11 July 2017), consilium.europa.eu/en/press/press-releases/2017/07/11/banking-action-plan-non-performing-loans.

stood at a comfortable 165.5%').[6] Notwithstanding these data, when pandemic-related public guarantee schemes and payment deferrals come to an end, it is reasonable to expect a robust build-up of new NPLs.[7] Indeed, according to ESRB the incidence of NPLs in the more vulnerable economies of the euro-area are likely to have an unprecedented impact in terms of the level, spread, and speed of accumulation on bank balance sheets.[8]

The revised Action Plan on NPLs that was made public on 16 December 2020 does not contain any significant change in respect to the 2017 Action Plan. The main initiative foreseen by the plan is the Proposal for a Directive of the European Parliament and the Council on credit servicers, credit purchasers, and the recovery of collateral.[9] However, many

[6] See EC, 'Action plan: Tackling non-performing loans (NPLs) in the aftermath of the COVID-19 pandemic' (Communication, 16 December 2020), ec.europa.eu/info/publications/201216-non-performing-loans-action-plan_en; EBA, *Risk Dashboard – Data as of Q3 2020* (2020), eba.europa.eu/sites/default/files/document_library/Risk%20Analysis%20and%20Data/Risk%20dashboard/Q3%202020/961888/EBA%20Dashboard%20-%20Q3%202020.pdf.

[7] Andrea Enria, 'Letters to the Members of the European Parliament' (Frankfurt am Main, 4 December 2020), bankingsupervision.europa.eu/ecb/pub/pdf/ssm.mepletter201204_Zanni_Donato_Grant_Rinaldi~37e7a4bd25.en.pdf?10a3f84d59483c0c4f5fda01df41a5cd; José Manuel Campa and Mario Quagliariello, 'Lessons From the Regulatory Response to the Covid-19 Crisis' (2021) 1 European Economy – Banks, Regulation, and the Real Sector european-economy.eu/2021-1/lessons-from-the-regulatory-response-to-the-covid-19-crisis.

[8] European Systemic Risk Board, 'ESRB report on the financial stability implications of COVID-19 support measures to protect the real economy' (Press release, 16 February 2021), esrb.europa.eu/news/pr/date/2021/html/esrb.pr210216~4d9cec6a0b.en.html.

[9] EC, *Directive of the European Parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral* (Proposal, 14 March 2018) COM (2018) 135 final.

obstacles stand in the way of effective implementation of these proposals in times of recession. Some are political in nature; others stem from the difficulty of harmonizing national insolvency laws.

In this paper, attention is focused on two obstacles deriving from the lack of flexibility of the current regulatory framework. First, the accounting and prudential rules on NPLs are analysed to verify whether the current regulatory framework provides the most effective solutions in times of recession. Second, a deeper look is taken of the legal constraints established by the current regulatory framework, with particular attention to the rules contained in the Bank Recovery and Resolution Directive (BRRD),[10] that may hinder full use of all possible tools to promote an efficient secondary market of NPLs.

2.1. Prudential rules on NPLs in time of recession

Much progress has been made in recent years in Europe in the harmonization of the accounting and supervisory reporting rules of Non-Performing Exposure (NPE), as well as in the field of prudential provisioning expectations. NPEs are broadly defined and include NPLs.

With regard to reporting rules, the EBA fostered convergence within the EU on a common system of supervisory reporting on loan quality, establishing uniform criteria to define 'NPE in its Implementing Technical Standard (ITS) on Forbearance and

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[10] Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council [2014] OJ L 173, 190–348.

Non-Performing Exposures'.[11] According to the abovementioned rules, NPEs are assets that satisfy either of the following two criteria: (a) material exposures that are more than 90 days past due; or (b) the debtor is assessed as unlikely to pay its credit obligations in full without realization of collateral, regardless of the existence of any past due amount or the number of days past due.

A significant step to introduce a uniform European framework of provisioning rules for NPEs has been made by the SSM with the Guidance Addendum concerning the minimum coverage of NPEs,[12] followed by the publication of the final text on 15 March 2018.[13] In particular, the most recent version of the guidelines is focused on prudential provisioning expectations, according to which banks must adopt a calendar approach consisting of gradually writing down new NPEs over time until they are fully written-off at the end of a given period. More specifically, new NPEs, even those stemming from credit

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[11] EBA, *Final Draft Implementing Technical Standards On Supervisory reporting on forbearance and non-performing exposures under Article 99(4) of Regulation (EU) No 575/2013* (24 July 2014) EBA/ITS/2013/03/rev1 eba.europa.eu/sites/default/documents/files/documents/10180/449824/a55b9933-be43-4cae-b872-9184c90135b9/EBA-ITS-2013-03%20Final%20draft%20ITS%20on%20Forbearance%20and%20Non-performing%20exposures.pdf?retry=1.

[12] ECB, *Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non-performing exposures* (October 2017), bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl2/ssm.npl_addendum_draft_201710.en.pdf.

[13] ECB, *Addendum to the ECB Guidance to banks on non-performing loans: supervisory expectations for prudential provisioning of non-performing exposures* (March 2018), bankingsupervision.europa.eu/ecb/pub/pdf/ssm.npl_addendum_201803.en.pdf?81e79e706d0c3c817ea11d094a678ea8. To note that the addendum only applies to significant euro-area banks and specifies quantitative supervisory expectations concerning the minimum level of prudential provisions for new NPLs (from 2018 onwards).

already granted in the past, must be fully written down within two years (when uncovered) or progressively within seven years (if covered) from the time they are classified as such. Those measures were transposed in the first level legislation in 2019 through the amendment of Regulation (EU) 575/2013 containing rules on minimum loss coverage of NPEs.

Prudential supervisory measures (accounting, supervisory reporting, and provisioning expectations) have certainly improved banks' ability to efficiently manage risks and have accelerated the cleaning of banks' balance sheets from bad loans with undisputed advantages in order to preserve the solvency of the individual intermediary.

Nevertheless, these rules establish a system of inflexible constraints which do not always allow the authorities to choose the most effective and suitable solutions to address the difficulties faced by banks in times of recession.
First, accounting and reporting rules reduce the discretion of banks in the valuation of individual risk positions, leading under certain objective conditions to the classification of a loan as non-performing, regardless of the assessment of a financed company's viability for the future.[14] This approach aims at preserving the bank's soundness and solvency, but, at the same time, it inevitably reduces the space for banks to manoeuvre when assessing the debt positions of companies affected by the lockdowns imposed by public authorities for public health reasons. To fix this problem, the extraordinary measures adopted by national governments, regulators, and supervisory

[14] Elisabetta Montanaro, 'Non-Performing Loans and the European Union Legal Framework' in Mario P. Chiti and Vittorio Santoro (eds), *The Palgrave Handbook of European Banking Union Law* (Palgrave Macmillan Cham 2019) 213-246.

authorities are not enough to mitigate the negative impact of the COVID-19 pandemic on the economy mainly due to the extraordinary and therefore transitory nature of these measures. In other advanced legal systems, such as the US, a loan is required to be placed on non-accrual status when payment in full of principal or interest is not expected or the asset is 90 days or more past due unless the asset is both 'well secured' and 'in the process of collection'. The definition is very similar to that adopted in Europe; nevertheless, it is not a statutory definition but a supervisory practice,[15] that allows authorities great flexibility in its application.

Second, the decision to establish minimum loss coverage for non-performing exposures, detailing the different coverage requirements depending on the classifications of the NPLs as 'unsecured' or 'secured' and whether the collateral is movable or immovable in the Level 1 Regulation (amending Regulation (EU) 575/2013 in April 2019) can hinder a prompt and flexible answer from supervisory authorities due to an unexpected event. Differently, the rules outlined in the ECB Addendum only imply an 'act or explain' mechanism, meaning that, during the supervisory dialogue in the context of the Supervisory Review and Evaluation Process (SREP), significant institutions are requested to justify any divergence from the prudential provisioning expectations outlined in the Addendum. Given the specific circumstances, the Joint Supervisory Team (JST) may evaluate that the coverage provided by the individual credit institution is not sufficient to cover the expected credit risk, thus imposing the adoption of 'Pillar 2' measures. This approach

[15] Patrizia Baudino et al., 'The identification and measurement of non-performing assets: a cross-country comparison' (April 2018) Financial Stability Institute FSI Insights on policy implementation No 7, bis.org/ fsi/publ/ insights7.pdf.

allows authorities to tailor supervisory measures to the specific conditions of each bank. Differently, minimum legal coverage levels for loans established in 2019 with the amendments to Regulation 575/2013 lack any flexibility in responding to bank-specific conditions.[16] The NPLs prudential regulation shows that the legislative instrument it is not suitable to supervise banking activity in times of uncertainty.

2.2. The BRRD inflexible legal constraints

As pointed out above, both the 2017 Action plan and the revised Action plan published in 2020 provide for measures aimed at favouring the creation of an efficient and transparent secondary market for NPLs. To this end, the Commission drafted a Proposal for a Directive of the European Parliament and the Council on credit servicers, credit purchasers and the recovery of collateral (COM (2018) 135 final). The proposal contains rules on access, supervision, and operation of credit servicers in the secondary market which are important for fostering the harmonisation of this activity in Europe, thus contributing to the creation of conditions for a potential cross-border circulation of NPLs. Furthermore, the proposal also contains rules aiming at increasing debt recovery efficiency through the implementation of a common AECE (Accelerated Extrajudicial Collateral Enforcement). AECE are out-of-court mechanisms whose goal is that of accelerating the collection of the collateral's value. They certainly help credit institutions to easily sell NPLs to credit purchasers and, as a consequence, clean up their balance sheets more rapidly, but it is questionable if this legal

[16] Ignazio Angeloni, 'Non-performing loans: an old problem in a new situation' (2021) 1 European Economy – Banks, Regulation, and the Real Sector, european-economy.eu/2021-1/non-performing-loans-an-old-problem-in-a-new-situation.

mechanism is sufficient to cope with the discrepancies currently present among Member States with regard to the time and cost of enforcement and the resulting recovery rates for NPLs.

Furthermore, the Commission's approach presents two weaknesses. First, the harmonization of the rules requires a timeline which is incompatible with the need to have an efficient market for NPLs to face the current recession. In addition, having common rules in Europe to favour the sale of a bank’s assets may not be enough. Indeed, although markets can develop autonomously, the process can be too slow, especially when faced with the urgent needs dictated by the recession caused by the COVID-19 pandemic. In this context, many proposals have been advanced to foster the growth of NPL exchanges. Many of them provide for State intervention. Indeed, the State has a longer investment horizon rather than the objective of maximising short-term profits will help to overcome the problem of the depressed market value of NPLs during recessions, attracting more banks into the market and increasing its depth. Many authors have argued that a single EU platform or a network of national government-sponsored AMCs would provide significant benefits in terms of fostering lower funding costs and higher operational efficiency, thereby attracting new investors to this market.[17] Other instruments

[17] Andrea Enria et al., ‘Completing the Repair of the EU Banking Sector’ (2017) 1 European Economy – Banks, Regulation, and the Real Sector, european-economy.eu/2017-1/completing-the-repair-of-the-eu-banking-sector-a-critical-review-of-an-eu-asset-management-company; Marco Lamandini et al., ‘Does Europe Have What it Takes to Finish the Banking Union?’ (2018) Columbia Journal of European Law 233; Edoardo Gaffeo and Ronny Mazzocchi, ‘“The price is right”: using auction theory to enhance competition in the NPL market’ (2019) 20 Journal of Banking Regulation 104-112; and Concetta Brescia Morra et al., ‘Non-performing loans. New risks and new policies. What factors drive the performance of national asset management

have also been under consideration to complement a set of measures to face the NPLs issues, such as Asset Protection Schemes (APS) envisaged as part of securitization transactions of NPLs (State guarantees on the senior tranches of securitization notes), NPLs trading platforms, and direct sales.[18]

The implementation of these proposals is currently hampered by some regulatory constraints that did not exist at the time of the GFC. In fact, in the context of the global financial crisis (2008-2011) several countries opted for the design of system-wide government-sponsored companies to address the sudden deterioration of the credit market in the aftermath of the global financial crisis. The European Commission considered the set-up of FMS Wertmanagement in Germany, National Asset Management Agency (NAMA) in Ireland, Sociedad de Gestión de Activos procedenets de la Reestructuración Bancaria (SAREB) in Spain, and Družba za Upravljanje Terjatev Bank (DUTB) – also known as Bank Asset Management Company (BAMC) in Slovenia – to be compatible with the internal market by qualifying the State intervention as an 'aid to remedy a serious disturbance in the economy of a Member State,' according to Article 107 (3)(b) of the Treaty of the Functioning of the European Union (TFEU).

This time is different because an inflexible legal constraint stands in the way of the use of those tools. Indeed, Article 32(4)(d) of the BRRD approved in 2014 provides that a bank

companies' (May 2021) Study request by the ECON committee, European Parliament, europarl.europa.eu/think tank/de/document.html?reference=IPOL_STU%282021%29651390.

[18] John Fell et al., 'Overcoming non-performing loan market failures with transaction platforms' (November 2017) Financial Stability Review – Special features, ecb.europa.eu/pub/pdf/other/ecb.sfafinancialstabilityreview201711.en.pdf.

receiving an 'extraordinary public financial support' should be put into resolution. This provision makes interventions by States much more complex and difficult. Indeed, according to the Commission (EC Commission 2018),[19] any impaired asset aid granted in the context of a transfer of NPLs from a bank to a publicly-supported AMC constitutes 'extraordinary public financial support'. Consequently, a bank benefitting from such an impaired asset measure (IAM) should thus in principle be resolved or liquidated, unless some particular and specific conditions are met, such as those envisaged for the precautionary recapitalization.[20]

Based on this new regulatory framework, Asset Protection Schemes and publicly-funded AMC have been set up only in very specific cases. Reference can be made to the Hungarian[21] AMCO named MARK and the Italian Securitisation Scheme[22] approved by the Commission according to the Market Economy

[19] EC, *Commission Staff Working Document AMC Blueprint Accompanying the document Communication from the Commission to the European Parliament, the European Council, the Council and the European Central Bank Second Progress Report on the Reduction of Non-Performing Loans in Europe* (14 March 2018) SWD(2018) 72 final, [eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018 SC0072&from=EN](eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018SC0072&from=EN).

[20] ibid ('subject to a case-by case assessment, precautionary recapitalization may be used to enable a removal of impaired assets from beneficiary bank's balance sheet. Such a transaction, if properly structured, may achieve exactly the same recapitalization objective for the beneficiary bank as a straight-forward injection of own funds or purchase of capital instruments. In case of an impaired asset relief measure, the bank is allowed to sell the NPLs at a price higher than market price (but not exceeding the assets' real economy value (REV)). Therefore, the capital position of the bank is preserved by reducing the upfront loss').

[21] EC in Case SA.38843 (2015/N) – Hungary C(2016) 820 final (Brussels, 10 February 2016).

[22] EC in Case SA.43390 (2016/N) - Italy - Italian securitisation scheme C(2016) 873 final (Brussels, 10 February 2016).

Investor Principle – MEIP,[23] meaning that if a Member State intervenes as a private investor would have accepted and is remunerated for the risk assumed in a way a private investor would have accepted, the intervention is not classified as State aid.

Article 32(4)(d) severely limits the discretion conferred by Article 107 TFEU on the Commission.[24] The latter rule establishes that, under certain conditions and on the basis of a case-by-case assessment by the Commission, an 'aid may be considered to be compatible with the internal market.'[25] The Commission used the discretion conferred on it by the Treaty to deal with the consequences of the pandemic. Indeed, the EC Communication of 19 March 2020 establishes a Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak. The Amendment to the Temporary Framework for State aid measures, approved on 8

[23] The statement of this criterion dates back to the mid-1980s; among others it refers to the decisions of the European Court of Justice (ECJ), Case 234/84, Kingdom of Belgium v. Commission of the European Communities; ECJ, Case C-301/87, French Republic v. Commission of the European Communities; ECJ, Case C-303/88, Republic of Italy v. Commission of the European Communities; ECJ, Case C-261/89, Republic of Italy v. Commission of the European Communities; ECJ, Cases C-278/92 to C-280/92, Kingdom of Spain v. Commission of the European Communities. Further, for a more recent case, see ibid.

[24] Concetta Brescia Morra, 'Management of Banking Crises and State Aid in Times of Coronavirus' (2021) European Banking Institute Working Paper Series 2021 – no 81.

[25] Consolidated Version of the Treaty on the Functioning of the European Union, [2012] OJ C 326/47 (the aid is deemed compatible in two different cases: when it is necessary "to remedy a serious disturbance in the economy of a Member State" (Article 107(3)(c)) and when it is granted "to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest" (Article 107(3)(d)).

May 2020, allows the use of State aid in times of pandemics also in favour of banks, providing that if, due to the COVID-19 outbreak, banks should need extraordinary public financial support, such measures would be deemed to fall under point 45 of the 2013 Banking Communication, which sets out an exception to the requirement of burden-sharing by shareholders and subordinated creditors.

Nevertheless, Article 32(4)(d) limits the possibility of granting State aid outside the context of a resolution procedure of a bank to a few cases and only under strict conditions.

This paper does not challenge the political choice of significantly reducing public intervention to manage banking crises. However, fixing rigid and inflexible rules may tie the hands of the Commission when facing an unexpected and dramatic crisis as it is in the post-pandemic recession.

3. Conclusion: the need for flexibility of the regulatory framework

The case of NPLs shows that the recent strategy of the European institutions to establish in detail prudential supervisory rules, or solutions and tools for managing banking crises in the Level 1 regulation is not the best solution, especially in historical moments of great uncertainty on the macroeconomic scenario. To the contrary, granting administrative authorities large discretion in the implementation of the Level 1 rules is the most effective way to reach two different goals which are not easy to reconcile due to the current uncertainty of the macroeconomic scenario: fostering the ability of banks to continue to finance businesses without jeopardizing financial stability. Certainly, this approach is optimal in the context of the Banking Union in which there is a single supervisory authority for all the euro-area countries, while it leaves room for opportunistic behaviours in the context of the European Union with multiple supervisory authorities. Indeed, a single authority that ensures uniform application of the rules prevents regulatory arbitrage by countries that might tend to apply prudential rules more loosely to favour national intermediaries. Despite this objection, it must be taken into account that the conduct of supervisory authorities which deviates from prudential standards to favour their own intermediaries in a competitive market can lead to a loss of confidence on the part of the markets to the detriment of that financial system. In any case, it appears that the benefits of a flexible regulatory approach outweigh any disadvantages.

In conclusion, I propose that the regulatory process should again be based on the architecture established in 2001 by the Lamfalussy Report.[26] The Lamfalussy regulatory approach involved four institutional levels. According to the Report, Level 1, represented by basic laws adopted by the European Parliament and Council in the traditional co-decision procedure, upon a proposal by the Commission, is usually complex and time-consuming. For this reason, the Report recommends using Level 1 laws only for setting out framework principles. At Level 2 the Commission can adopt, adapt, and update technical implementing measures with the help of consultative bodies composed mainly of EU country representatives (currently the EBA that prepares the draft of RTS or ITS for the banking sector). Implementing guidelines to standardise supervisory practices issued by the EBA represents the Level 3 regulation.

[26] The Committee of Wise Men, *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets* (Brussels, 15 February 2001), esma.europa.eu/sites/default/files/library/2015/11/lamfalussy_report.pdf.

Level 4 provides a strong role for the Commission in ensuring the correct enforcement of EU rules by national governments.

In conclusion, the regulatory process, as originally envisaged in 2001 by the Lamfalussy Report,[27] appears today to be the most suitable for reconciling the need for uniform rules in Europe with that of maintaining a system of flexible rules, easily adaptable to changes in economic scenarios.

[27] ibid.

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7. Non-performing loans in the pandemic crisis and the Directive on preventive corporate restructuring

Juana Pulgar Ezquerra & Juan Ignacio Signes de Mesa[*]

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1. Introduction

The economic crisis caused by the current pandemic, whose effects and duration remain unknown, has required providing liquidity to companies, mainly those of micro, small and medium size (SMEs), whose business models are highly dependent on cash income. Financial institutions and banks, which were part of the problem in the 2008 financial crisis, have instead been part of the solution to the current crisis.

The first urgent and temporary measures adopted under the regulatory framework related to the pandemic aim at favouring the financing of SME companies in various ways. In practice, the most usual source of micro- and small-corporate financing

[*] Views expressed in this article are strictly personal.

is their own shareholders, who are often reluctant to capital increases and prefer, as an alternative, to finance their companies by means of loan. In certain bankruptcy models, as the Spanish one, this implies an automatic debt subordination. Nonetheless, this rule has been temporarily disabled until 2022, so that insiders' claims are classified as ordinary claims[1]. Another way to provide liquidity to companies is bank financing supported by national public authorities in accordance with the temporary framework on state aid adopted by the European Commission[2]. This method of financial support is usually articulated through public guarantees and moratoria, whose main objective is to prevent the costs that a systemic default on payments would generate for the financial system.

However, the current economic crisis increases the default risk and, therefore, the number of non-performing loans. Since the 2008 financial crisis, the rates of these loans were under control and had even decreased according to the 2017 Council Action Plan[3]. By contrast, the Commission has recently published a notice on non-performing loans in the current pandemic

[1] Spanish Law 3/2020 of 18 of September on procedural and organizational measures to face Covid-19 in the field of Justice Administration, Article 7.

[2] EC, 'Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak' (Communication) COM (2020) 1863 final. The State aid Temporary Framework was adopted on 19th March 2020 to enable Member States to use the full flexibility foreseen under State aid rules to support the economy in the context of the coronavirus outbreak. Since its adoption, the Temporary Framework has been amended on 3 April, 8 May, 29 June and 13 October 2020 and 28 January 2021. Its application has been extended until 31 December 2021.

[3] Council of the EU, 'ECOFIN Action plan to tackle non-performing loans in Europe' (Press release, 11 July 2017), consilium.europa.eu/en/press/press-releases/2017/07 /11/banking-action-plan-non-performing-loans.

context[4], which foresees an increasing number of bankruptcy proceedings, as well as a significant impact, in terms of provisions, for the financial entities that act as professional creditors.

Other international bodies have also alerted about this fearsome situation. First, as in previous occasions, the World Bank group has warned about the growing number of bankruptcy proceedings on non-performing loans[5]. It compares 2017 and current ratios and highlights the serious risks for the financial system. Likewise, the European Systemic Risk Board (ESRB) has made relevant predictions on the declaration of insolvency proceedings in a Covid-19 context and its impact on the banking sector[6]. The World Bank Group and the ESRB agree on the need to adopt temporary and structural measures to avoid the accumulation of non-performing loans on the balance sheets of financial institutions in the medium term. The ultimate goal is to protect the financial system and its role in supporting the economic recovery for companies, predominantly micro and small businesses, without putting financial stability at risk.

It is worth distinguishing between preventing the accumulation of non-performing loans, on the one hand, and their treatment

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[4] EC, 'Tackling non-performing loans in the aftermath of the COVID-19 pandemic' (Communication, 16 December 2020) COM (2020) 822 final, eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52020DC0822.

[5] World Bank Group, 'The Calm Before the 'Storm: Early Evidence on Business Insolvency Filings After the Onset of COVID-19' (25 February 2021) COVID-19 notes, Finance series, documents1.worldbank.org/curated/en/962221615273849133/pdf/The-Calm-Before-the-Storm-Early-Evidence-on-Business-Insolvency-Filings-After-the-Onset-of-COVID-19.pdf.

[6] ESRB, *Prevention and management of a large number of corporate insolvencies* (April 2021), esrb.europa.eu/pub/pdf/reports/esrb.report210428_PreventionAndManagementOfALargeNumberOfCorporateInsolvencies~cf33e0285f.en.pdf.

once occurred, on the other. Several measures can be adopted to this respect, most of which require a pro-active approach by banks. They must identify distressed debtors in due time and provide them with liquidity, in order to avoid or minimize potential non-performing loans. Public support measures by Member States must also be adopted and implemented in accordance with the State aid regime recently relaxed by the Commission, as it had happened during the 2008 financial crisis. It is also necessary to draw attention to the need to develop secondary markets to place non-performing loans by financial institutions. As the ESRB points out, they play an important role in order to enhance the securitization of non-performing loans considering they respect initial creditors' protection.

In addition, the Commission, the World Bank, and the ESRB insist on the need for Member States to adopt insolvency reforms to avoid a deterioration of the economic situation. The purpose is to design not only predictable, effective, and expedited bankruptcy procedures, but also early corporate restructuring frameworks, an area where the transposition of the Directive 2019/1023 on restructuring and insolvency[7] acquires a relevant role for business recovery in a post-COVID scenario. The first term of transposing the Directive expires in July 2021. However, Member States that encounter difficulties in implementing this Directive shall be able to benefit from a one-

[7] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 [2019] OJ L 172 (Directive on restructuring and insolvency).

year extension as long as they had informed the Commission about it by January 2021.

Directive 2019/1023 aims to harmonize preventive restructuring frameworks and liability exemption mechanisms for individuals as a means to avoid traditional bankruptcy procedures. According to the new harmonization regime, it should be possible to distinguish between viable companies – i.e., companies whose operating value is higher than their liquidation value – and non-viable companies, subject to immediate winding up. Preventive restructuring procedures ensure that appropriate measures precede default on companies' loans. This action seeks to reduce the risk of non-performing loans and allows, when occurred, finding solutions through negotiation or contractual mechanisms. Thus, the cost for financial institutions in terms of provisions, which affect their liquidity levels, should also decrease.

Furthermore, Directive 2019/1023 foresees not only the possibility of consensual restructurings, meaning agreements with large majorities of creditors, but also non-consensual restructurings for dissident creditors, debtors, and shareholders. It seeks to defeat traditional 'hold-out' scenarios, in an attempt to overcome the well-known principle of *relative effects of contracts*. The Directive starts from the premise that company law shall not hinder the restructuring of viable companies. Accordingly, several measures may be imposed on shareholders in order to incentivize them to cooperate on the restructuring of their company. Highly relevant to this respect is the possibility to convert debt into equity, which would allow creditors to become equity holders.

Non-consensual restructurings were tested through the restructuring of financial institutions within the framework of the Directive 2014/59 on recovery and resolution of credit institutions and investment firms[8], which also serves to test such non-consensual restructurings in the sphere of non-financial companies.

In the following section, the meaning, advantages, and disadvantages of non-consensual restructuring in the financial sector are examined in order to introduce its application to non-financial sectors under Directive 2019/1023 and to present it as a step towards the reduction of the risk of non-performing loans in the context of the current economic crisis.

2. Restructuring of the financial system: bail-in and non-consensual cram-down

Following the 2008 crisis, the financial system in most Member States went through a deep process of restructuring. This process was carried out in accordance with Directive 2014/59, which represented a commitment in favour of bail-in measures, as opposed to bail-out programs. The latter ones are considered forms of State aid, which entail not only an impact on taxpayers, but also an increase in the risk of moral hazard and the establishment of a dangerous link between sovereign debt and an economic crisis.

The term 'bail-in', as opposed to the term 'bail-out', appears in Directive 2014/59 and Regulation 806/2014, establishing a

[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 [2014] OJ L 173.

Single Resolution Mechanism and a Single Resolution Fund[9] with a double meaning[10].

On the one hand, 'bail-in' is mentioned as one of the resolution tools for credit institutions applicable by the administrative authority when the conditions set forth in Article 33 of Directive 2014/59 and in Article 27 of Regulation 806/2014 are fulfilled. As academics have pointed out[11], 'bail-in' is the authentic resolution tool introduced in the Directive deviating from the negotiated or contractual nature of other instruments, such as the sale of assets. As a resolution tool, a bail-in can be used alone as an internal measure to recapitalize credit institutions, or in combination with other tools as a means to provide capital to a 'bridge' bank and complement the sale of its assets separately or as a going concern entity. Bail-in constitutes a mere mechanism for absorbing losses, and not a way for the entity to regain its viability in order to continue the exercise of its essential functions in the market. This is the essential purpose of the harmonized resolution regulated in Directive 2014/59.

On the other hand, the term bail-in is related to the concept of reductions or write-offs and cases of conversion of debt to

[9] 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 [2014] OJ L 225.

[10] Karl-Philipp Wojcik, 'Bail-in in the Banking Union' (2016) 53 Capital Markets Law Review 91, 106 (who refers to bail in as an 'umbrella term').

[11] Wolf-Georg Ringe, 'Bank Bail-in between Liquidity and Solvency' (2018) 92 American Bankruptcy Law Journal 299, 306 (referring to a third way between two traditional opposing tools in banking crisis, in particular the provision of liquidity by the European Central Bank to illiquid banks and the winding-up of insolvent banks).

equity. Strictly speaking, they do not constitute resolution tools. They can actually be applied independently or in combination with a resolution tool in accordance with Article 37(3) of Directive 2014/59 and Articles 21 and 27 of Regulation 806/2014.

As a resolution tool, 'bail-in' refers to a new competence legally granted to public authorities to decide that losses of a credit institution, which it incurs in a non-viability scenario, must be assumed, first, by its shareholders and, second, by creditors, in accordance with the classification of their credits in the framework of an ordinary insolvency procedure. The initial purpose was to apply bail-in measures only to specific creditors, in particular, to providers of 'regulatory capital'[12]. Later, it was extended to ordinary and subordinated claims, with the exception of those specifically protected and excluded in the Directive 2014/59 and included in the single resolution mechanism according to Regulation 806/2014[13].

All this through a special administrative procedure that differs from traditional insolvency procedures. Resolution of credit institutions is justified on the grounds of public interests served by banks that allow the alignment of concurrent rules of public

[12] At a first stage, providers of regulatory capital did not refer to all creditors of a bank, but only to those participating in the "core equity instruments", "core equity tier", "hybrid instruments" and "tier 2 instruments". This means, in short, creditors who would be subordinated if an insolvency proceeding was initiated. See Concetta Brescia Morra, 'Lending activity in the time of coronavirus' in Christos Gortsos and Wolf-Georg Ringe (eds), *Pandemic Crisis and Financial Stability* (EBI 2020).

[13] See Christos Gortsos, 'Considerations on the application of the NCWO principle under the SRM regulation' (2021) European Banking Institute Working Paper Series 2021 – no. 88, ssrn.com/abstract=3807971, and in Revista General de Insolvencias y Reestructuraciones (I&R), 1/2021, 23-43, iustel.com/v2/revistas/detalle_revista.asp?numero=1&id=10.

and private law in the banking sector. In the same way as the incorporation of a credit institution and the beginning of its operations are subject to administrative authorisation, so is the treatment of the economic difficulties it may experience. The disappearance of the conditions necessary for granting the initial authorisation is handled now by administrative law norms, even if using corporate law techniques[14].

Bail-in is thus established, not as a contractual solution to a bank's economic difficulties agreed upon by shareholders and creditors, but rather as a non-consensual cram-down, statutorily imposed and exercised by administrative authorities that have a wide discretion of action within this framework. Indeed, the resolution authority can determine the existing classes of shares or instruments that may be cancelled or transferred to creditors subject to bail-in. Moreover, with respect to creditors, the resolution authority may decide to convert debts into shares or other instruments. Such a decision entails an accounting mechanism that modifies the structure of the bank's balance sheet and may imply sometimes the dilution of the position of existing shareholders [see Articles 47(1)(b) and 63(1)(f) of Directive 2014/59].

This new approach to financial restructuring implies the replacement of a state aid system by an effective mechanism that requires investing creditors to take into account a bail-in scenario and to make an analysis of the entity's liability structure, including the debt ratio that would be outside 'bail-in' in order to predict its position in such a context. Consequently, if creditors conclude that the possibility of bail-

[14] Simon Gleeson, 'Legal aspects of bank 'bail-ins'' (2012) LSE Financial Markets Group Paper Series – Special Paper 205, fmg.ac.uk/sites/default/files/2020-10/SP205.pdf.

in is substantial and that they may face higher losses in such a case than under an insolvency proceeding, they may likely demand a higher rate of return to invest in debt instruments issued by a bank.

Bail-in measures represent the use of restructuring techniques originated in company law and justified by the corporate nature of financial institutions. They take the form of an administrative cram-down of shareholders who have to assume the losses of the investee bank outside of a negotiated or contractual framework[15]. In this regard, the novelty of Directive 2014/59 does not derive from the compulsory nature of a bail-in restructuring, as regulated in Chapter 11 of the US Bankruptcy Code, which has inspired the European harmonization of corporate restructuring under Directive 2019/1023[16]. It results from the administrative nature of the cram-down which might be subject to judicial control *a posteriori*. This is the main difference to traditional insolvency procedures which are of judicial nature. Besides, non-consensual bail-in differs from the cram-down in non-financial institutions with respect to its compulsory imposition on creditors, in particular those who have invested in bank-subordinated debt instruments. It should be emphasized that the legal basis of assuming equity stakes is neither contractual nor the result of a decision made by the majority of creditors. It is of regulatory nature, supported by a decision made by the respective administrative authority.

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[15] See Juana Pulgar Ezquerra, *Preconcursalidad y reestructuración empresarial* (3rd edn, Wolters Kluwer 2021). Also, on ‘regulatory cram-down’, see Lynette Jennssen, ‘Bail-in from an insolvency law perspective’ (2018) 33 Journal of International Banking Law and Regulation 8.

[16] See Juana Pulgar Ezquerra, ‘Risoluzione della banca e bail-in’ (2020) 95 Diritto fallimentare e delle società commerciali 750.

This can certainly affect shareholders' rights as recognized in Directive 2017/1132[17]. Yet, the underlying assumption is that company law should not be an obstacle in relation to the resolution or specific restructuring of credit institutions, nor should it be in relation to the restructuring of non-financial companies, as analysed hereafter. This objective can be found at recital 121 of Directive 2014/59 and finds a similar parallelism in Directive 2019/1023, even if the mechanisms to overcome company law under each Directive are different.

In fact, Directive 2019/1023 establishes two different ways to achieve this objective. First, it empowers judges to adopt decisions regarding the restructuring of the company in lieu of the general meeting – for example, the decision of debt-equity-swap. Second, it treats shareholders as a class of creditors and, as such, submits them to a cross-class cram-down process, in which Member States are able to choose between an absolute or relative rule, as a protection mechanism for dissenting classes. By contrast, in Directive 2014/59, these options are regulatory in nature. Company law is set aside by virtue of an administrative decision on the grounds of public interest. No absolute or relative priority rules, typical of pre-bankruptcy corporate restructurings, are applicable in these scenarios.

Academics have rightly highlighted the special status of creditors of a financial institution. They actually become *creditore sub iudice*, subject to a non-consensual change in their position, if the entity is non-viable in accordance with a public

[17] Directive (EU) 2017/1132 of the European Parliament and of the Council of 14 June 2017 relating to certain aspects of company law [2017] OJ L 169 (SRD II).

interest[18]. They face therefore the risk of bearing, despite their status as shareholders, the entity's losses. For this reason, it is certainly relevant to introduce effective mechanisms to safeguard or protect shareholders and creditors in the framework of the restructuring of credit institutions. In Directive 2014/59, these mechanisms are fragile, especially in the context of bail-in. The protection level of stakeholders under a bail-in scenario is compared to the level of protection under a hypothetical scenario of an insolvency proceeding with liquidation (*no creditor worse off* principle, NCWO). This ultimately depends on the valuation of the entity's assets and liabilities[19], which is often controversial in practice, as evidenced in the context of the Banco Popular case in Spain.

The reasons that justify this change, from consensual restructuring to mandatory and regulatory administrative restructuring, are the following ones.

First, as already noted, the concurrence of public and private interests in economic crises challenging the viability of financial entities, with the prevalence of the former over the latter. In this area, the interests of taxpayers emerge, since they must not bear the consequences of mismanagement of credit institutions and the deficiencies of conventional restructuring. Capital plays here an important preventive role, as financial institutions are required to have an adequate level of regulatory capital, made up of a balanced combination of subordinated debt and hybrid capital[20]. It should be noted that, in theory, a

[18] See Pierre De Gioa Carabellese, 'Crisi della banca e diriti dei creditori' (Collana di Studi sull' Integrazione Europea, Cacucci Editori 2020).
[19] See ibid n 14.
[20] On the functions and structure of banks' capital see Douglas W. Diamond and Raghuram G. Rajan, 'A Theory of Bank Capital' (2000) 55 Journal of Finance 2431.

high level of regulatory capital could ensure that, in ordinary insolvency proceedings, a bank's losses would be borne, first, by shareholders and subordinated creditors and, then, by depositors and the economy as a whole. However, in cases of unexpected losses, this may not provide sufficient satisfaction of investors' claims, especially in situations where short-term solutions are necessary. The conversion, by non-financial companies, of debt into equity in a conventional manner is also problematic, especially when shareholders are not in a position to inject supplementary capital.

It is true that banks can issue contingent capital instruments, including contingent convertible bonds (CoCos) and write-down bonds. These usually provide a clause that allows to liquidate them or to convert them into ordinary or privileged shares when a trigger event occurs and when the bank considers itself 'going concern'. However, the advantage of bail-ins, as provided in Directive 2014/59, is that they come into force not only after contractually agreed trigger events occur, but also when the resolution authority exercises its discretionary power to take the appropriate resolution action. In these cases, bail-in must, in any case, precede the application of contingent capital instruments issued by credit institutions, as a complement for them[21].

Second, non-consensual bail-ins of administrative nature have a relevant impact on the property rights of shareholders and creditors, regarding their titles and credits. Also from a contract law perspective, since a bail-in decision by the administrative authority affects the object and purpose of their contractual

[21] See Patrick S. Kenadjian, 'CoCos and Bail-Ins' in Andreas Dombret and Patrick S. Kenadjian (eds), *The Bank Recovery and Resolution Directive* (de Gruyter 2013) 229.

relationship with the financial institution. This poses the question of whether the decision of the administrative authority means a novation of an imperative nature or rather a supervening impossibility of fulfilling the terms of the contract.

In this contractual area, the goal is to avoid that a judicial decision of a Member State, on the debts of a bank under resolution established in another Member State, would compromise the effectiveness of the administrative cram-down initiated in the latter one. For this reason, the so-called 'contractual recognition of bail-in' is regulated in Article 55 of the Directive 2014/59, as a means to guarantee the resolvability of the entity. The rationale is to make the bail-in more effective and conclusive as well as to ensure that the power of the administrative authority – to convert, devalue or cancel – within a bail-in is not affected by the decision of a judicial authority of another Member State. In this framework, each Member State must require credit institutions, when issuing their securities or debt, to introduce a contractual clause by virtue of which creditors express, through a formal declaration, that their debt can be converted into capital. Article 55(1) of Directive 2014/59 defines the conditions under which this contractual clause must be included. In fact, the contractual recognition of bail-in increases the effectiveness of a cram-down in the context of banking resolutions.

3. Non-financial restructuring: Directive on restructuring and insolvency

So far, the treatment of non-financial debtors in distress has not been harmonized in the European Union. The sole harmonization achieved concerns Regulation 2015/848, on insolvency proceedings[22], which regulates relevant matters of jurisdiction, recognition, enforcement, conflicts of laws and cooperation in cross-border insolvency proceedings.

The absence of harmonization indicates that there are substantial differences between the bankruptcy legal regimes of Member States, particularly with respect to the mechanisms that allow debtors to overcome, or at least minimize, the effects of their inability to fulfil their payment obligations. In the context of an economic crisis, this can give rise to forum shopping cases; cases where debtors, in particular legal persons, shift

[22] Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings [2015] OJ L 141. It is worth highlighting, however, that at European level, the attempts to harmonize insolvency law have been numerous. Thus, see, in connection with Directorate General for Internal Policies, Policy Department C: Citizens, Rights and Constitutional Affairs, *Harmonization of Insolvency Law at EU Level* (PE429.633, 2010) and, European Parliament, *Resolution of 15 November 2011 with recommendations to the Commission on insolvency proceedings in the context of EU company law* (2011/2006(INI), 2001), EC, 'Single Market Act II Together for new growth' (Communication to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions) COM (2012) 573 final, with which the Commission undertook the modernization of insolvency rules in the European Union. See, in addition, Council Directive 2001/23/EC of 12 March 2001 on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses [2001] OJ L 082, which regulates the rights of workers in cases of transfer of companies and, in particular, article 5 on insolvency proceedings. Furthermore, see EC, 'A new European approach to business failure and insolvency' (Communication to the European Parliament, the Council and the European Economic and Social Committee) COM (2012) 742 final, which later gave way to the Commission Recommendation of 12 March 2014 focused on pre-insolvency and restructuring. This document relates to EC, 'Building a Capital Markets Union' (Green Paper) COM (2015) 63 final, which was subject to public consultation. Based on this heterogeneous interest groups (such as banks, pension funds, workers' unions, research institutions, etc.) promote a substantive harmonization of bankruptcy law.

towards jurisdictions that are more favourable to their interests. Forum shopping enhances regulatory competition between Member States, but also implies costs.

In the context of pre-bankruptcy restructuring, there was an inclination to adopt the UK model of 'schemes of arrangement' that are associated, among other things, with high solicitor costs. Due to Brexit, such schemes may, currently, give rise to problems of court decisions' recognition.

Nevertheless, the situation will change after the transposition of Directive 2019/1023. In fact, this directive was preceded by Commission's Recommendation of 12 March 2014 on 'A new approach to insolvency and business failure'[23] and can be a decisive step towards the creation of a European insolvency law. Directive 2019/1023 harmonizes substantive aspects of insolvency law, not only procedural aspects, as it happened with the cross-border insolvency regulation.

Directive 2019/1023 is important not only for the harmonisation of European insolvency law, but also because it is based on a new paradigm of business insolvency connected to corporate governance. The new paradigm aims to promote business start-ups and business continuity as well as the maintenance of employment. It is structured around two basic premises: the prevalence of pre-bankruptcy restructuring solutions and the second-chance mechanisms for individual entrepreneurs, reminiscent of the US system. Actually, Directive 2019/1023 establishes a close link with the US restructuring approach, in particular with Chapter 11 of the Bankruptcy Code, which since 1978 encourages the restructuring and reorganization of

[23] EC Recommendation (2014/135/EU) of 12 March 2014 on a new approach to business failure and insolvency [2014] OJ L 74.

companies in crisis as well as discharge mechanisms for individuals.

However, it should be noted that, while Directive 2019/1023 promotes an American-style incentive for restructuring companies in distress, such incentive is addressed differently in Chapter 11 of the Bankruptcy Code. Directive 2019/1023 favours restructuring in a pre-bankruptcy venue with minimal judicial intervention, in a similar way to the UK ‘schemes of arrangement’ model, given the economic, time and reputational costs arising from judicial bankruptcy restructurings. By contrast, in American federal law, the rationale is to encourage judicial restructuring of companies in distress, according to a ‘second chance’ philosophy. Not only through an agreement, but also through transnational settlements providing for the transfer of productive units in operation. This is justified by the fact that, in the American bankruptcy system, there is no obligation for the managers of the distressed company to file for a bankruptcy procedure when the company is insolvent as well as by the absence of stigmatization for debtors in the scenario of a bankruptcy procedure. In American law, it should also be noted that out-of-court negotiations are encouraged and thoroughly regulated.

Directive 2019/1023 is based on a corporate governance approach in a context of insolvency or potential insolvency that is also typical of Anglo-Saxon models and that is essential to face business recovery in the EU in a post-COVID and post-Brexit economic environment.

Based on economic theory, corporate governance has the function of resolving conflicts of interest that arise where an agent (directors) manages resources owned by another principal (shareholders). More specifically, agency theory distinguishes three types of agency problems, which arise, first, between directors and shareholder(s), second, between controlling shareholders and minority shareholders and, third, between the corporation and its creditors[24].

Traditionally, in European continental jurisdictions, corporate crises are usually treated in the field of corporate governance as a problem inherent to company law, thus related to the rules that govern the fundamental aspects of the organization of listed companies. From an economic perspective, it is a matter of resolving, with greater or lesser success, the first two agency problems, which are the conflict between management's interests and shareholders or between shareholders themselves. The third agency conflict that may arise against creditors in situations of insolvency is excluded from the scope of corporate governance.

Directive 2019/1023 is grounded on the consideration that the debate on corporate governance in the EU cannot remain focused on the relationships between directors and shareholders, and between the latter. It must also address the third agency conflict with respect to other stakeholders, in particular with respect to creditors.

It is actually in situations of insolvency or potential insolvency where the third agency conflict becomes manifest, even though it is not a conflict that arises at that moment. Certainly, such a conflict arises when the creditor enters into a relationship with

[24] See Richard A. Posner, *Economic Analysis of Law* (9th edn, Wolters Kluwer Law & Business 2014), 4; John Armour, Henry Hansmann, Reinier Kraakman, and Mariana Pargendler, 'What is Corporate Law' and John Armour, Henry Hansmann and Reinier Kraakman, 'Agency Problems and Legal Strategies' in *The Anatomy of Corporate Law, A comparative and Functional Approach* (3rd edn, OUP 2017) 29.

the company, since shareholders seek to maximize their investment, in the short or the long term, while creditors expect to satisfy their claims through corporate assets. As long as companies can comply with their obligations towards creditors, it is a latent conflict. However, this conflict becomes apparent when companies start facing economic difficulties and culminates in the occurrence of insolvency, a moment when bankruptcy law comes into play.

In this context, the substantive harmonisation of preventive restructuring procedures in the EU, through Directive 2019/1023, allows the creation of a legal *tertium genus,* which brings together bankruptcy and company law. Restructuring could be entrusted not only with a function of satisfying creditors, but also, where appropriate, with a function of reallocating control rights in distressed companies close to insolvency[25].

The previous approach to corporate governance is evident in Directive 2019/1023 at least in three areas. First, in the necessary involvement of equity in the restructuring process, including eventual changes of control and non-consensual restructurings, not only for creditors but for shareholders as well. Second, in the consideration by the administrators of the interests not only of the shareholders, but also of other stakeholders, such as creditors, workers, etc. Finally, in the possibility foreseen in the Directive to introduce an alert system in cases of economic difficulties, at least with respect to SMEs.

[25] See, from a mathematical and financial perspective with respect to US law, Lucian Arye Bebchuk, 'A New Approach to Corporate Reorganizations' (1988) 101 Harvard Law Review 775.

The objective pursued by Directive 2019/1023, as it results from recitals 2 and 3, is very ambitious, since, in principle, it seeks to restructure viable companies close to insolvency (i.e., companies whose going concern value is higher than their liquidation value). All is about maximizing, in a balanced way, the value of corporate assets in favour of creditors, shareholders as owners of the company, and the economy as a whole, preserving jobs. It prevents the build-up problem of non-performing loans for banks, which must early detect economic difficulties of borrowers in order to ensure that action is taken before companies default on their loans. Thus, they will be able to adopt measures to avoid the declaration of a judicial bankruptcy procedure and the liquidation of viable companies. Liquidation can have an indirect penalizing effect on financial entities in terms of their income statements and provisions.

Directive 2019/1023 promotes the liquidation of companies that are not economically viable. Member States must introduce measures in their bankruptcy laws to improve efficiency and avoid the growth of the so-called 'zombie companies' as the OECD has warned. This risk increases in the current context of the pandemic and its consequent economic crisis[26].

Moreover, Directive 2019/1023 introduces second-chance mechanisms for individuals, which represent an exception to the principle of universal succession of liabilities and that ultimately seeks to promote business activities without the disincentive of the strict application of such a principle ('fresh start').

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[26] Dan Andrews, Müge Adalet McGowan and Valentine Millot, 'Confronting the zombies: Policies for productivity revival' (2017) OECD Economic Policy Paper No. 21, doi.org/10.1787/f14fd801-en.

Directive 2019/1023 establishes minimum harmonizing principles that reflect the compromise reached in the last phase of the political negotiations that preceded its adoption. The European legislator makes available to Member States a range of instruments (‘tool-box’) that allow the regulation, and even the introduction *ex novo*, of pre-bankruptcy restructuring mechanisms that precede judicial insolvency proceedings. It also aims to restructure not only liabilities, as occurs in refinancing, but also assets, which reflects an important change in the objectives of the Directive.

The *de minimis* approach of Directive 2019/1023 makes us wonder whether the harmonization of preventive restructuring arrangements has been achieved, given that Member States are left with wide discretion concerning its transposition, encouraging the maintenance of current forum shopping phenomena. Nevertheless, in our view, the Directive will enhance a healthy competition between jurisdictions as a means of attracting investment[27].

At least, Directive 2019/1023 allows Member States to regulate preventive restructuring procedures of a pre-insolvency nature. Article 2(1)(1) of the Directive adopts a very broad concept of restructuring, which covers not only liabilities, but also the assets of the debtor's business. It also includes measures such as the modification of the terms and conditions of the debtor’s

[27] See the classical paper by Robert K. Rasmussen, ‘The Ex Ante Effects of Bankruptcy Reform on Investment Incentives’ (1994) 72 Washington University Law Quarterly 1159, on the relationship between investment and insolvency law reforms. With respect to the measures adopted in Germany for the transposition of the Directive in order to promote investments, see Stephan Madaus, ‘A role model for implementing the restructuring Directive? The new German Law for preventive restructuring procedures in Germany’ [2021] Spanish Journal of Insolvencies & Restructuring (I&R) 211.

liability: write-offs, delays, capitalization of credits and other measures of modification of the existing liability or the reorganization of its assets through the sale of certain assets of the debtor or of the company.

Directive 2019/1023 embraces, as a general rule, the consensual nature of restructurings. Yet, it also foresees scenarios of non-consensual restructuring, not only for creditors, in an attempt to overcome holdout and free riding problems, but also for debtors, that is, for shareholders, who may be willing to block the adoption of necessary corporate resolutions on the grounds of traditional paradigms of corporate and contract law. This is the reason why, terminologically, Directive 2019/1023 refers not to restructuring 'agreements', but to restructuring 'plans', which, in principle, will be consensual, although they can also be compulsory.

Additionally, Directive 2019/1023 introduces new paradigms with respect to classical approaches in the framework of restructurings. One of these is the principle of *the best-interest-of-creditors* in the context of the cram-down within each creditor class [Article 10(2)(d)]. This is measured under a restructuring scenario and compared to the value that would be attributed to creditors in case of liquidation or the best-alternative-scenario, if the restructuring was not successful. Furthermore, the so-called *absolute priority rule* regarding the cram-down of an entire class of creditors is nuanced in the Directive. Member States can opt in a *relative priority rule* as a means to safeguard parties [Article 11(1)(b)].

Directive 2019/1023 is structured on the basis of four basic pillars: early warnings, restructuring plans, and incentives for new financing and interim financing, as well as liability exemption mechanisms, that is, second-chance mechanisms that promote a fresh start with respect to individuals. Their analysis is essential insofar as they will be determining factors in the introduction of important reforms.

It is not worth analysing at this stage the full range of measures provided by Directive 2019/1023. It is more relevant to focus instead on non-consensual restructurings vis-à-vis creditors, which may encourage negotiated agreements in an attempt to avoid judicial bankruptcy procedures. Furthermore, we will focus on non-consensual restructurings vis-à-vis shareholders, which may impose, for instance, debt-to-equity-swaps, which could constitute a way to prevent and, where appropriate, treat the possible problem of non-performing loans in the current context and the eventual economic crisis[28].

4. Non-consensual restructuring and the entry of banking into capital

4.1. Consensual cram-down: forced restructuring of creditors.

4.1.1. Cram-down of creditors within each class: the best-interest-of-creditors.

When the cram-down of creditors occurs within a class, the protection of dissidents or non-participating creditors whose claims are affected by the adopted plan is based on the 'the-best-interest-of-creditors-test', as provided by Article 10(2)(d) of Directive 2019/1023. It is a minimum and mandatory requisite for the confirmation of the restructuring plan. As defined in article 2(1)(6) of the Directive, by reference to

[28] This issue is however controversial and may give rise to certain debate. See Matthias Lehmann, 'Mothballing the economy and the effects on banks' in Christos Gortsos and Wolf-Georg Ringe (eds), *Pandemic Crisis and Financial Stability* (EBI 2020). In our view, however, this is a valid option considering recital 3 of Directive 2019/1023.

section 1129(a)(7) of the US Bankruptcy Code, this test requires that no dissenting creditor shall be worse off 'under a restructuring plan than such a creditor would be if the normal ranking of liquidation priorities under national law were applied, either in the event of liquidation, whether piecemeal or by sale as a going concern, or in the event of the next-best-alternative scenario if the restructuring plan were not confirmed'[29].

The rationale for this principle is consistent with the economic objectives of Directive 2019/1023 with respect to pre-bankruptcy restructuring. To avoid unfair treatment of dissident creditors, the going concern value of the restructured company ('reasonable market value') must be greater than the value of the company in liquidation. The difference between the 'restructuring value' and the 'liquidation value' is the surplus that results from keeping the business operating despite its financial difficulties. This value is to be distributed among creditors, as a general rule, in a consensual manner or, exceptionally in the case of forced restructuring, in an imperative way through the cram-down of creditors.

However, as we already mentioned, in the last stages of legislative negotiations, Article 2(1)(6) of the Directive added, next to the liquidation scenario, the possibility for Member States to determine the best alternative solution in case a restructuring plan is not confirmed[30]. In our view, this provision

[29] Concerning the functioning of this rule under US law, see Jonathan Hicks, 'Foxes Guarding the Henhouse: The Modern Best Interests of Creditors Test in Chapter 11 Reorganizations Note' (2005) 5 Nevada Law Journal 820.

[30] See Nicolaes Tollenar, *Pre-insolvency proceedings: a normative foundation and framework* (OUP 2019) 183; Riz Mokal, 'Fairness' in Lorenzo Stanghellini, Riz Mokal, Christoph G. Paulus and Ignacio Tirado (eds), *Best practices in European restructuring: contractualised distress resolution in the*

is questionable since it introduces insecurity and uncertainty regarding the question of what would be the best alternative scenario to the liquidation and liquidation quota. In addition, it carries a litigation risk, so it seems advisable not to opt for this possibility of contemplating an alternative scenario to that of liquidation in the transposition of the Directive.

4.1.2. Cram-down of creditors' entire classes. Absolute priority rule vs. Relative priority rule.

In non-consensual restructuring plans, in which the cram-down affects an entire class of creditors, the protection of this class is regulated in Article 11 of Directive 2019/1023. The so-called *absolute priority rule* applies in these cases. It derives once again from the US system, specifically from section 1129(b)(2)(B) of the Bankruptcy Code, from which it adopts the protection of *senior* creditors; they will be paid off preferentially before *junior* creditors and shareholders.

In accordance with this latter rule, for a plan to be confirmed by a judicial or administrative authority, it is necessary, in addition to the requirements set forth in Articles 10(2) and 10(3) of the Directive, to be approved by a majority of the voting classes of affected parties, provided that at least one of those classes is a secured creditors class or is senior to the ordinary unsecured creditors class; or, failing that, at least one of the voting classes of affected parties or, where so provided under national law, impaired parties, other than an equity-holders class or any other

shadow of the law (Wolters Kluwer & CEDAM 2018) 37, codire.eu/wp-content/uploads/2018/11/Stanghellini-Mokal-Paulus-Tirado-Best-practices-in-European-restructuring.-Contractualised-distress-resolution-in-the-shadow-of-the-law-2018-1.pdf; and Riz Mokal and Ignacio Tirado, 'Has Newton had his day? Relativity and realism in European restructuring' [2019] Butterworths Journal of International Banking Financial Law 233.

class which, upon a valuation of the debtor as a going concern, would not receive any payment or keep any interest, or, where so provided under national law, which could be reasonably presumed not to receive any payment or keep any interest, if the normal ranking of liquidation priorities were applied under national law.

Under this premise of confirmation of the plan, in accordance with Article 11(1) (c) of the Directive, to extend the effects of the plan to a dissident class, the affected creditors who vote against it must receive at least equal favourable treatment as any other category of the same rank and more favourable than any category of lower rank. Therefore, no class of creditors could receive or retain under a restructuring plan any form of value if the dissident classes of senior creditors are not fully repaid in cash or in kind. This means that until a dissident class of creditors that is 'in the money' is not fully satisfied, a junior class will not be able to receive anything. It implies inter alia the respect of the order of priority in a conventionally agreed payment.

Article 11(1) (d) of Directive 2019/1023 also provides that 'no category of the affected parties may receive or keep more than the total amount of their credits or interests'. As indicated above, this entails a protection mechanism for junior classes of creditors. The US reverse rule is in this way incorporated into EU law, according to which a senior class in no case can receive more than 100% of its credit and any excess of the restructuring value should be distributed to the junior classes of creditors or shareholders (see recital 55 of the Directive).

The *absolute priority rule* has traditionally been considered, as already mentioned, the way to respect the order of priority in a conventionally agreed payment. It constitutes a basic element of credit protection, without which creditors would refrain from financing companies. It also mitigates the risk of 'blackmailing' scenarios, since dissident senior classes of creditors must be paid in full before a junior class can receive any payment. Thus, the risk that lower-ranking creditors could appropriate part of the value that corresponds to creditors of higher rank disappears.

Furthermore, the *absolute priority rule* constitutes the most powerful incentive when negotiating a plan with junior creditors and shareholders. Implicitly, if these know that, in a non-consensual restructuring they would not receive anything until the senior classes have been fully satisfied, this would encourage them to reach consensual plans that avoid compulsory restructurings.

However, this rule entails a certain rigidity. It discourages those who know that they would not receive anything in case of restructuring from participating in negotiations for such a plan. That is junior classes of creditors or residual claimants, such as shareholders. For this reason, Article 11(1) (c) of Directive 2019/1023 provides for Member States the possibility to opt for the *relative priority rule* as an alternative to the *absolute priority rule*, when shareholders maintain certain interests in the plan. For example, as it results from recital 56 of the Directive, 'where it is considered fair that equity holders maintain certain interests under the plan despite a more senior class being obliged to accept a reduction of its claims, or that essential suppliers covered by the provision on the stay of individual enforcement actions are paid before more senior classes of creditors'. This is despite the fact that a higher priority category is forced to accept a reduction in their credit claims so that suppliers of basic supplies receive their payment before them.

Based on the *relative priority rule*, the complete satisfaction of a senior class of creditors resulting in partial compensation of inferior classes, is replaced by the best treatment of the preferred class. This entails the need to determine quantitatively the best treatment and to determine who is responsible to define it. In short, judges must verify whether 'the best treatment' is sufficient to fulfil this condition for the purposes of an eventual cram-down of an entire class of creditors.

By this approach, those who would not receive anything until a senior class has been fully satisfied under the *absolute priority rule*, or those on whom the continuity of the company's activity depends, can receive some compensation as an incentive to continue to be involved in the restructuring.

In the EU, an intense academic controversy has arisen over the appropriateness of each rule. It is positive to reopen an essential debate on the incentives and pressures of shareholders in the negotiation process of restructuring plans. However, in our opinion, the debate has been out of focus for two reasons. First, because the *absolute priority rule* has never been so absolute in practice, not even within the scope of the reorganizations regulated by Chapter 11 of the US Bankruptcy Code. Exceptions to this rule have been admitted to the extent that, since its introduction in 1978, the complexity of the participants in restructurings has increased. The US Supreme Court has declared that classes can voluntarily accept different treatment under the *absolute priority rule* as long as the 'best-interest-test' is satisfied. It has also admitted the so-called 'new value exception', meaning the buy-back or retention by shareholders of their interests (equity interests) in the surplus value of the restructuring of the company, by making monetary contributions to the debtor. Second, the debate is not focused because the Directive does not replace the *absolute priority rule*, as a general principle, by the *relative priority rule*. The latter is only an option for member countries in the transposition of the Directive.

The major drawbacks that the option for the *relative priority rule* entails are the two following ones. On the one hand, the distortion of the conventionally agreed credit rankings, with a likely negative impact on the credit market; on the other hand, highly important, this rule has not been the object of a prior impact assessment, nor has it been accepted so far in any Member State.

This may advocates the establishment of the *absolute priority rule* as a starting point for the transposition of the Directive, with joint provision of possible legally defined exceptions (for example, with respect to strategic commercial creditors or certain suppliers). In this regard, it must be borne in mind that shareholders can be incentivized not only on the basis of eventual counterparties for their old instruments, as the *relative priority rule* pretends by distorting credit rankings, but also on the basis of the future value of the plan.

4.2. Non-consensual restructuring of the debtor. The role of capital in restructurings.

As already indicated, Article 2(1) of Directive 2019/1023 adopts a very broad concept of the term ‘restructuring’. It covers not only liabilities, but also the assets of the company. It includes measures such as the modification of the terms and conditions of the debtor’s liability – such as write-offs, waits, capitalization of credits and other measures of modification of the existing liability – or the reorganization of its assets, through the sale of certain assets of the debtor or of the company as a going concern. A restructuring plan can therefore include these measures or other measures, expressly provided for in the Directive, and even additional measures such as the injection of new financing.

In this context, restructuring requires the adoption of corporate initiatives, which, in accordance with the distribution of powers between the different corporate bodies, correspond to resolutions made in shareholders' meetings. In situations of insolvency or potential insolvency, potential conflicts of interest may arise between, on the one hand, majority and minority shareholders and, on the other, shareholders and company directors or creditors.

Indeed, shareholders seek to maximize their economic interests, either through short- or long-term corporate strategies. By contrast, creditors seek to fully satisfy their claims through corporate assets. For this reason, the economic difficulties of a company can incentivize shareholders to reduce the corporate wealth, diverting assets in their favour or increasing the debt of the company, especially through banking financing. Moreover, investment in new potentially profitable projects may be reduced if shareholders anticipate the benefits to be attributed to creditors and not be distributed to them as dividends. Shareholders can also exercise their right of veto in the adoption of agreements that could facilitate restructurings, such as the conversion of debt to equity, which would sometimes dilute their position in the company.

What is clear in this context is that to divert value in favour of shareholders, who are *ex lege* subordinated in the capital structure, or allowing them to make decisions hindering a restructuring, must be a decision in accordance with the rules of corporate governance, broadly understood, comprising the resolution of eventual agency problems between shareholders and creditors[31].

Directive 2019/1023 highlights the tension and traditional separation between bankruptcy and company law when dealing with insolvency. This is also a consequence of the traditional XIX[th] century private conception of shareholders as owners of the company and holders of its participation and economic rights, as it results from the Second Company Law Directive. For this reason, the economic objectives of the Directive 2019/1023 challenge this traditional paradigm, confronting current company law with the traditional approach in the EU.

The basis of this Anglo-Saxon approach is that company law should not constitute an obstacle to the restructuring of viable companies. In turn, it is understood that, when shareholders are 'out of the money' – that is to say, when their residual claims would not be fully or partially satisfied by the liquidation value of the company and, thus, they would not receive any liquidation quota from the company – they may jeopardize the restructuring. In this case, restructuring may be forced on them, without any expropriation effect, since their position as shareholders in the company would lack financial grounds. In Directive 2019/1023, the implicit model is that of listed companies. The rationale of the non-consensual restructuring is

[31] Some authors, rightly in our view, refer to issues related to the 'bankruptcy decision', from an Anglo-Saxon perspective. This is the joint decision that shareholders and creditors (integral parts of a company's capital structure) must adopt in relation with a company under a restructuring process, applying the rules of corporate law in the context of insolvency law. This dialectic relationship is characterized as 'corporate governance under financial distress' or 'a special form of corporate governance'. See Horst Eidenmüller, 'Comparative corporate insolvency law' in: Jeffrey N. Gordon and Wolf-Georg Ringe (eds), *The Oxford Handbook of Corporate Law and Governance* (OUP 2018) 1003.

mostly economic and derives from the duty of shareholders to favour the restructuring of the company and not to hinder it (duty of loyalty).

The breakdown of this paradigm is not, however, new. As pointed out, it was previously tested with success, even though with frequent litigation, in the field of bank restructuring, within the framework of Directive 2014/59. Based on the principle of *burden share*, no aid of public nature can be granted until shareholders and creditors have sacrificed their respective interests.

The difference between cram-down vis-à-vis shareholders under Directive 2019/1023 and the restructuring of financial institutions under Directive 2014/59 is that, in the non-financial sector, the restructuring does not have an administrative and regulatory nature. It is based on the consensus of a large majority of creditors, as well as on the economic valuation of the company. Consequently, if equity is zero and shareholders are ‘out of the money’, their participation loses economic support and their participation rights in the company get depleted. In fact, in this scenario, creditors become the owners of the company and, therefore, shareholders’ opposition to the adoption of restructuring measures becomes hard to be materialized.

However, the problem with this approach, as in case of bank restructuring, is that it requires a prior evaluation of the company. The evaluation of the economic situation of the company as a prerequisite for its restructuring, meaning the assessment of the degree of deterioration and proximity to insolvency, determines the demands imposed on shareholders. For this purpose, the value of the company after the restructuring (i.e., the reorganized value) must be taken into account. It is actually an aspect that debtors and creditors may substantially disagree about. At this stage, the company's liquidation value, as determined by market participants, is compared to a hypothetical and unverified restructuring value. There is no single common valuation method. So, creditors are ultimately satisfied not on the basis of cash distributions, but on the basis of estimates that may ultimately turn out to be wrong.

By contrast, in cases where the value of the company is lower than the debt, shareholders will be 'out of the money' and would not be entitled to veto a restructuring. Obviously, this veto right, while protecting the positions of the debtor and creditors, is not sufficient to achieve a restructuring. It can lead to an impasse situation, which is to be overcome through the forced restructuring provided in the Directive, based on the ratification of the plan by a judicial or administrative authority and large majorities of creditors.

This constitutes one of the most remarkable progresses of the Directive, but also one of the most complex aspects of its transposition, insofar as it connects the role and duties of shareholders in the restructuring of the company.

Besides this, Directive 2019/1023 does not harmonise the way in which Member States should prevent shareholders from blocking the restructuring of a viable company without reasonable cause. In fact, the Directive refers to each Member State in order to determine the notion of 'reasonableness', mainly taking into account the size and dimension of the company concerned, as well as the way in which such obstruction is to be avoided.

Indeed, the Directive considers holders of shares or participations as an 'affected class of creditors', meaning, as residual claimants, with voting rights, subject to a cram-down in a forced restructuring of the debt, such as other creditors, after judicial or administrative approval, based on the provisions of Article 11 of the Directive. In order to promote and encourage the participation of shareholders in the adoption of restructuring measures, Member States may exclude the rule of absolute priority. If shareholders, being the lowest ranking class of creditors, foresee that they will not receive any compensation until senior creditors have been fully satisfied, this would constitute a disincentive for their participation.

From this perspective, Directive 2019/1023 confers on restructuring plans a function of reassigning control rights over the company, particularly in cases of debt conversion. It enables the substitution of traditional deductions (write-offs) in cases of preventive restructuring. Based on the evaluation of the company, even when shareholders hold the formal ownership of the company's equity, creditors have the material ownership as they bear the business risk. The exercise of voting rights by shareholders lacks economic grounds.

In this context, if the value of the company is higher than its debt, shareholders could veto a restructuring that crams them down and can dilute their position in the company. By contrast, if the value of the company is lower than its debt, shareholder's veto would not be justified since, in these circumstances, the company would actually belong to the creditors.

It is worth highlighting the impact that Directive 2019/1023 has with respect to changes in the control of distressed companies as a protection mechanism for funders, particularly in the control of listed companies. These cases are grounded on the premise of dissociation of property and control rights. On many occasions, shareholders do not add value to the company, not more than a mere investor, so they can be replaced under certain conditions in favour of restructuring financed by holders of debt instruments. This would readjust the control rights in the company in a post-restructuring scenario.

The approach with respect to closely held companies is different, since Member States are entitled to exclude the possibility of forced restructuring of shareholders according to Article 11(d) *in fine*. These companies can voluntarily submit themselves to the application scope, in order, for example, to improve their access to credit. This option is justified, on the one hand, because, unlike large, listed companies, shareholders can add value to the company undergoing restructuring, even being essential for its success. On the other hand, in closely held companies, the readjustment of control rights can come through contractual agreements establishing pledges on shares that allow the financing creditor to take control of the company (execution by appropriation) when the event of default occurs. The latter explains the success of the so-called ‘Luxembourgish pledge’.

However, in listed companies, this contractual solution, while possible, is unlikely in practice. It is not feasible to take a pledge on all or most of the shares given the dispersion of capital that characterizes these companies. The legal system covers this inconvenience through Directive 2019/1023, which allows financing creditors, to seize, under certain conditions, the company’s capital by converting debt into equity, within the framework of a preventive restructuring plan, applicable to shareholders against or without their will.

The alternative option for Member States is to put in place effective instruments to prevent shareholders from hindering the restructuring without reasonable cause. Directive

2017/1132 provides for the option, not the obligation, of Member States to establish exceptions to the requirements associated with the obligation to call the general meeting and to offer preferential shares to existing shareholders. Such exceptions are allowed in order to prevent partners from frustrating a restructuring by misusing these rights[32]. This is equivalent to admitting that shareholders are not holders of absolute rights within the company.

In our opinion, this is an option that alters the competences of the general meeting and a complex deviation from classic paradigms established through the Second Company Law Directive. It also entails a more stringent framework for administrative authorities with regard to their eventual responsibility for restructuring the company[33]. The best option would be considering shareholders as a class of residual claimants and apply to them the non-consensual restructuring plan, if it is necessary.

However, this forced restructuring solution has at least two problems. First, it has a possible risk of expropriation of shareholders' rights in the company, which has already been noticed in forced restructurings of the financial sector through the bail-in mechanisms, with consequent litigation. As pointed out, the non-consensual restructuring vis-à-vis shareholders is directly connected with the economic valuation of the company, for which there is no single common valuation method. The method depends on the determination of whether shareholders retain some value in the company and, therefore,

[32] Directive on restructuring and insolvency, recitals 57 and 96.
[33] Directive on restructuring and insolvency, recital 57.

whether the application of a compulsory conversion of debt into equity might be expropriatory for them.

5. Final remarks: food for thought

In the context of the Commission's agenda on the banking union, Directive 2019/1023 seeks to contribute to preventing the accumulation of non-performing loans. The availability of effective preventive restructuring frameworks would ensure that action is taken before companies default on their loans, thereby reducing the risk of loans becoming non-performing in cyclical downturns and mitigating the negative effect on the financial sector.

Nevertheless, this is not the only link between non-performing loans and Directive 2019/1023. This Directive introduces new paradigms in the field of company law with respect to the role and position of shareholders and other equity holders when the company is insolvent or likely to be insolvent.

Member States should ensure that the adoption of restructuring plans, which can bring the debtor back to viability, cannot be unreasonably prevented. They should also be able to deviate from the requirements laid down in Directive 2017/1132, concerning the obligations to convene a general meeting and to offer shares to existing shareholders on a pre-emptive basis to the extent and for the period necessary to ensure that shareholders do not frustrate restructuring efforts by abusing their rights.

In this context, Member States can deploy different means to achieve this goal. First, by not giving equity holders the right to vote on a restructuring plan and by not making the adoption of a restructuring plan conditioned to the agreement of the 'out-of-the-money' equity holders, namely equity holders, who upon a valuation of the company, would not receive any payment or other consideration, if the normal ranking of priority classes was applied. Second, where equity holders have the right to vote on a restructuring plan, a judicial or administrative authority should be able to confirm the plan notwithstanding the dissent of one or more classes of equity holders, through a cross-class-cram down mechanism.

For these purposes, the Directive on early corporate restructuring introduces the possibility to impose, among others measures, debt-to-equity swaps under certain circumstances and with high approval rates by creditors. This means that creditors, particularly banks and financial creditors, would become shareholders as a way to reduce the risk of loans becoming non-performing, avoiding the negative impact of non-performing loans on their income statement, above all in cyclical downturns or special economic crises as, for instance, the current COVID crisis.

Nevertheless, in our view, banks and financial creditors do not seem to have an interest in becoming shareholders of their debtors, although, for illustrative purposes, a Spanish financial creditor has become shareholder of a company at a substantial percentage in the context of a preventive refinancing agreement[34].

In any case, it is important to analyse the advantages and disadvantages of it, in particular in the event the company finally files for a judicial insolvency proceeding. Firstly, it entails regulatory capital consequences for banks, which are not analysed in-depth in this paper because of editorial constrains.

[34] Abanca in relation to New pescanova refinancial agreement.

Secondly, it is important to highlight the risk for banks and financial creditors to be automatically considered as legal subordinated claimants, as insiders, since they are part of the debtor's equity after the debt-equity-swap. In countries such as Spain, it entailed a 'cruel punishment' given that these claims become automatically subordinated, although the latest reforms in the field of early corporate restructuring have introduced, in the context of the special and temporary COVID-legislation, an exemption to this subordination until 2022.

The transposition of Directive 2019/1023 will not likely constitute or lead to a return to industrial banking, typical of the '70s, by means of the conversion of debt into equity in favor of financial creditors, as non-performing loans will be dealt rather through negotiated solutions prior to the declaration of bankruptcy proceedings.

It is food for thought.

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SECTION III:
THE ROLE OF THE ECB

8. The ECB's response to the COVID-19 crisis and its role in the green recovery

Seraina Grünewald

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1. Introduction

The COVID-19 pandemic has triggered a myriad of economic policy initiatives by EU and national authorities. First and foremost a health crisis and human tragedy, the pandemic also caused the largest global recession in history. The European Central Bank (ECB) reacted fast and decisively to the extreme economic shock of the pandemic.[1] In light of the already low inflation rate and the long period of below-target inflation prior to the COVID-19 outbreak, the ECB provided additional monetary stimulus to restore momentum to inflation dynamics, including by conducting additional asset purchases under its

[1] For an overview of the ECB's monetary policy measures in response to the COVID-19 outbreak, see Christos Gortsos, 'The response of the European Central Bank to the current pandemic crisis: monetary policy and prudential banking supervision decisions' (2020) EBI Working Paper Series 2020 – no. 68, 9-14, papers.ssrn.com/sol3/papers.cfm?abstract_id=3650370.

pandemic 'flagship policy initiative', the Pandemic Emergency Purchase Programme (PEPP).[2]

This reaction affirms that the ECB, under the leaderships of Mario Draghi and Christine Lagarde, has turned into a central bank that actively addresses and counteracts crises along with fiscal and regulatory authorities.[3] The crisis containment measures initiated by the ECB have had the intended effects of stabilizing markets and protecting against the risk of a credit crunch.[4] Market conditions had improved before the Eurosystem even started buying bonds under the PEPP.[5] Throughout the different waves of the pandemic and the rapidly changing financial and macroeconomic conditions, the PEPP and other temporary measures have provided a historic degree of monetary accommodation. Without these measures, 'the euro area would presumably have experienced a severe economic and financial crisis with devastating consequences for society as a whole'.[6]

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[2] Philip R Lane, 'The pandemic emergency: the three challenges for the ECB' (Speech at the Jackson Hole Economic Policy Symposium, 27 August 2020), ecb.europa.eu/press/key/date/2020/html/ecb.sp200827~1957819fff.en.html.

[3] This new role goes hand in hand with the need and call for a more extensive accountability of the ECB, including through more exchange with the European and national parliaments – an issue that cannot be discussed in more depth here. See e.g. Nik de Boer and Jens van 't Klooster, 'The ECB, the courts and the issue of democratic legitimacy after Weiss' (2020) 57 CMLRev 1689; Ana Bobić and Mark Dawson, 'COVID-19 and the European Central Bank: The legal foundation of EMU as the next victim?' (*Verfassungsblog*, 27 March 2020), verfassungsblog.de/covid-19-and-the-european-central-bank-the-legal-foundations-of-emu-as-the-next-victim.

[4] Lane (n 2).

[5] Christine Lagarde, 'One year of the PEPP: many achievements but no room for complacency' (*The ECB Blog*, 22 March 2021), ecb.europa.eu/ press/blog /date/2021/html/ecb.blog210322~7ae5eca0ee.en.html.

[6] ibid.

As vaccination programmes are rolling out across Europe and lockdown measures are gradually being lifted, the gears are shifting from acute crisis management to supporting the economic recovery. Meanwhile, the long-term social and economic consequences of COVID-19 remain uncertain. In this second stage of pandemic crisis-related policies, the ECB has yet to find its role. The EU's political actors have made environmental sustainability a key priority in the joint efforts to put the European economy back on its feet. The Next Generation EU instrument, the recovery plan for Europe, is centered around the Recovery and Resilience Facility (RRF), adopted in February 2021, a EUR 672.5 billion facility designed to help Member States address the economic and social impact of the COVID-19 pandemic and to ensure that their economies undertake the green and digital transitions.[7] The green objective of economic recovery is further rooted in the European Green Deal, a roadmap of key policies and measures to transform the EU into a more sustainable economy and society, presented by the Commission in December 2019.[8] The European Green Deal sets out numerical targets, including a zero net emissions target for greenhouse gases (GHG) by 2050 as well as a collective, net GHG emissions reduction target of at least 50% (later updated

[7] At least 37% of the expenditure envisaged by Member States should contribute to climate objectives (alongside 20% of total investments to support digital transformation).

[8] EC, 'The European Green Deal' (Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of Regions, 11 December 2019) COM (2019) 640 final.

to 55%) by 2030 compared to 1990.[9] The European Climate Law will enshrine both targets in binding EU legislation.[10]

While fiscal and regulatory policies undoubtedly are the first in line to ensure that the necessary investments are raised and (re-)directed towards green economic activity, there is growing acknowledgement that the ECB has a role to play in the economic transformation as well.[11] However, much controversy still exists as to how far the ECB can and should go in supporting the green objective in the economic recovery. The ECB itself has made environmental sustainability a component of the ongoing review of its monetary policy strategy, along with financial stability and employment.[12] This is an acknowledgment of the fact that monetary policy has an impact on other (new) economic policy objectives, and vice versa, and must thus play its part in addressing major economic challenges

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[9] ibid 4, referring to: EC, 'A Clean Planet for all – A European strategic long-term vision for a prosperous, modern, competitive and climate neutral economy' (Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee and the Committee of Regions and the European Investment Bank, 28 November 2018) COM (2018) 773 final.

[10] On May 2021, it was announced that the Council's and the European Parliament's negotiators had reached a provisional political agreement on the European Climate Law. The compromise text can be found in pdf format at: data.consilium.europa.eu/doc/document/ST-8440-2021-INIT/en/pdf. See, in particular, Article 2 (climate-neutrality objective) and Article 3 (intermediate climate targets).

[11] Arruga Oleaga, however, might be too optimistic with his assessment that '[t]here is nowadays consensus' about the fact that 'the monetary policy of the ECB has to pursue the fight against climate change'. See Iñigo Arruga Oleaga, 'Introduction to the panel on the EU Taxonomy and action plan on sustainable finance: what uses for the ESCB?' in European Central Bank (ed), *ESCB Legal Conference 2020* (European Central Bank 2021) 112, 114.

[12] ECB, 'ECB launches review of its monetary policy strategy' (Press Release, 23 January 2020), ecb.europa.eu/press/pr/date/2020/html/ecb.pr200123~3b8d9fc08d.en.html.

of the 21st century. In an environment of low inflation and low interest rates, monetary and fiscal policies are particularly mutually dependent. This new reality of central banking increasingly challenges conventional 'monetarist paradigms' according to which monetary policy constitutes a strictly technical task that requires little discretion and should be conducted by an independent central bank under a narrowly interpreted legal mandate.[13]

This chapter briefly takes stock of the ECB's efforts to fight the immediate effects of the pandemic through PEPP and other (unconventional) monetary policy measures (Section 2.). In Section 3, it then turns to discussing the ECB's role in the green recovery in the years (and potentially decades) to come. The aim is to explore to what extent and in what ways the ECB could actively contribute to the green agenda of economic policymakers, both within the confines of and in fulfillment of its monetary mandate. Section 4 concludes.

2. Fighting the immediate effects of the pandemic: the Pandemic Emergency Purchase Programme and other (unconventional) monetary policy measures.

The Governing Council announced the establishment of the PEPP on 18 March 2020, with an original maximum size of EUR 750 billion.[14] In light of the prolonged economic fallout from the pandemic, it decided to increase the envelope of the PEPP by EUR 600 billion on 4 June 2020 and by an additional

[13] See de Boer and van't Klooster (n 3).

[14] ECB, 'ECB announces €750 billion Pandemic Emergency Purchase Programme (PEPP)' (Press Release, 18 March 2020), ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html. See also Decision (EU) 2020/404 of the ECB of 24 March 2020 on a temporary pandemic emergency purchase programme (ECB/2020/17) [2020] OJ L91/1.

EUR 500 billion on 10 December 2020 to a new total of EUR 1,850 billion. The PEPP includes all asset categories eligible under the pre-existing Asset Purchase Programme (APP).[15] There are, however, differences in the eligibility criteria compared to the APP. The minimum remaining maturity of marketable debt securities is shorter than under the APP.[16] Moreover, the Governing Council granted a waiver of the eligibility requirements under the APP for securities issued by the central government of the Hellenic Republic.[17]

While the allocation of cumulative net purchases of public sector securities under the PEPP is guided by the ECB's capital subscription key, purchases are conducted in a flexible manner on the basis of market conditions. This allows for fluctuations in the distribution of purchase flows over time, across asset classes and among jurisdictions.[18] ECB representatives stress the necessity of the disapplication of some 'previously self-imposed constraints', including issuer and issue limits, to ensure that the PEPP can address the uncertainty of the evolving crisis.[19] To prevent the APP from inheriting the more flexible features of the PEPP, PEPP purchases are deliberately made a

[15] (1) Marketable debt securities as under the Public Sector Purchase Programme (PSPP); (2) corporate bonds and other marketable debt instruments as under the Corporate Sector Purchase Programme (CSPP); (3) covered bonds as under the third Covered Bond Purchase Programme; and (4) asset-backed securities (ABSs) as under the Asset-backed Securities Purchase Programme.

[16] Under the PEPP, marketable debt securities must have a minimum remaining maturity of 70 days and a maximum remaining maturity of 30 years (Article 2 of Decision of the ECB [n 14]).

[17] ibid Article 3.

[18] ibid Article 5.

[19] Yves Mersch, 'Exploring the legal framework governing the ECB's actions: scope and general legal principles' in European Central Bank (ed), *ESCB Legal Conference 2020* (European Central Bank 2021) 9, 10.

distinct monetary policy measure and kept separate from the APP purchases.[20]

The unprecedented flexibility of the PEPP, while warranted by the exceptional crisis caused by the COVID-19 outbreak and constituting 'the PEPP's most precious asset'[21], has triggered much discussion on the legality of the programme in light of case law pertaining to the ECB's PSPP (*Weiss* case) and announcement of outright monetary transactions (*Gauweiler* case).[22] This discussion is symptomatic of a fundamental dilemma the ECB is increasingly confronted with: that it must justify its decisions and actions under a narrowly interpreted price stability objective that fails to accommodate the close interdependencies of monetary and other economic policies. Moreover, an austerity conditionality, elevated to the level of a quasi-constitutional principle, is difficult to reconcile with the need for gigantic fiscal measures to avert a health and economic disaster as a consequence of the COVID-19 outbreak. Should the constitutional interpretation of the monetary financing prohibition and the requirement of sound budgetary policy[23] not take into account that the objectives of solidarity and social cohesion[24] play a crucial part in the EU's efforts to deal with the effects of the pandemic?

[20] ibid 12.
[21] Lagarde, One year of PEPP (n 5).
[22] See e.g. Sebastian Grund, 'Legal, compliant and suitable: The ECB's Pandemic Emergency Purchase Programme (PEPP)' (2020) Hertie School Jacques Delors Centre Policy Brief, delorscentre.eu/en/publications/detail/publication/legal-compliant-and-suitable-the-ecbs-pandemic-emergency-purchase-programme-pepp; Bobić and Dawson (n 3); Annelieke AM Mooij, 'The legality of the ECB responses to COVID-19' (2020) 45 ELR 713.
[23] TFEU Articles 123(1) and 126.
[24] TEU Article 3(3), third subpara.

The Governing Council indicated that it would terminate net asset purchases under the PEPP once it determines that the COVID-19 crisis phase is over, but in any case, not before the end of March 2022. The Eurosystem will continue to reinvest principal payments from maturing securities purchased under the PEPP until at least the end of 2023.

The PEPP was not the only measure taken by the ECB in response to the pandemic and its economic fallout. With many SMEs hit hard by the COVID-19 outbreak, the Governing Council decided in March 2020 to make amendments to the third series of targeted longer-term refinancing operations (TLTROs-III).[25] It also introduced new pandemic emergency longer-term refinancing operations (PELTROs).[26] According to the ECB, the temporary amendments to the pre-existing refinancing operations have led to an increase in the provision of credit support to the real economy as well as related knock-on effects on asset prices.[27]

These measures were further complemented by a temporary easing of collateral eligibility requirements to enable Eurosystem counterparties to maintain sufficient eligible collateral, announced on 7 and 22 April 2020. The first package of measures facilitates banks' access to Eurosystem liquidity operations at favourable terms, including by a reduction of

[25] Decision (EU) 2020/407 of the ECB of 16 March 2020 amending Decision (EU) 2019/1311 on a third series of targeted longer-term refinancing operations (ECB/2020/13) [2020] OJ L80/23 (increasing the borrowing allowance, modifying the maximum bid limit and, starting from September 2021, offering an earlier repayment option); Decision (EU) 2020/614 of the ECB of 30 April 2020 OJ L141/28 (introducing an additional temporary reduction in interest rates applied to all TLTROs-III).
[26] Unlike TLTROs, PELTROs have a maturity of one year and are not linked to lending requirements.
[27] Mersch (n 19) 14.

valuation haircuts applied to collateral and by accepting Greek sovereign debt instruments as eligible collateral in Eurosystem credit operations.[28] The second package is aimed at pre-empting collateral shortages due to the effects of potential rating downgrades resulting from the COVID-19 pandemic and lockdown measures. The ECB grandfathered the eligibility of marketable assets and the issuers of such assets that met certain minimum credit quality requirements on 7 April 2020 in the event of a rating downgrade, to the extent that the ratings remain above a certain credit quality level.

3. Supporting the economic recovery: the ECB's role in the green transition.

With the prospect that vaccination programmes will bring an end to the public health crisis triggered by the COVID-19 outbreak, EU policy is increasingly turning its focus from acute crisis management to supporting the economic recovery. The same applies for the ECB's monetary policy. While the ECB's role of crisis manager might be challenged by individuals or groups in court,[29] it is unlikely to lead to broad political disapproval. In the eyes of the majority of people, the ECB has been doing precisely what a central bank is expected to do in an

[28] Guideline (EU) 2020/515 of the ECB of 7 April 2020 amending Guideline ECB/2014/31 on additional temporary measures relating to Eurosystem refinancing operations and eligibility of collateral [2020] OJ L110I/26; ECB Decision 2020/506 of the ECB of 7 April 2020 amending Guideline (EU) 2015/510 on the implementation of the Eurosystem monetary policy framework and Guideline (EU) 2016/65 on the valuation haircuts applied in the implementation of the Eurosystem monetary policy framework (ECB/2020/20) [2020] OJ L109I/1.

[29] Two cases challenging the legality of the PEPP are pending before the German Constitutional Court, lodged by the right-wing party Alternative für Deutschland (AfD) and by a group of 16 academics and business people, respectively.

unprecedented emergency like the COVID-19 pandemic: take forceful action to avert an economic disaster.

But what are the expectations in the ECB with a view to the upcoming period of economic recovery, including all the structural transformations this recovery is set to entail? In that respect, the views differ quite fundamentally. Some argue, much in line with the 'monetarist paradigm' that prevailed in the early 1990s when the Maastricht Treaty was drafted,[30] that the ECB should return as soon as possible to pursuing a narrowly interpreted price stability mandate on the basis of its pre-crisis (conventional) instruments. Others are more conscious of new (unanticipated) developments and challenges the ECB is confronted with and request a more flexible interpretation of its mandate.

It is amidst this controversy that the ECB is reviewing its monetary strategy,[31] alongside other Central Banks like the Fed.[32] A key question of this review precisely concerns the role of the ECB with a view to greening the economy – an objective the EU legislators have made a priority of economic policy in the years and decades to come. Should the ECB actively contribute to the objectives of the EU in the fight against climate change? And what could such active contribution look like?

[30] See de Boer and van't Klooster (n 3) 1693-1695.
[31] See (n 12).
[32] The Fed concluded the review of its monetary policy approach in August 2020 by updating its Statement on Longer-Run Goals and Monetary Policy Strategy, see Fed, 'Federal Open Market Committee announces approval of updates to its Statement on Longer-Run Goals and Monetary Policy Strategy' Press Release (27 August 2020), federalreserve.gov/newsevents/pressreleases/monetary20200827a.htm.

3.1. Price stability and environmental sustainability: what does the mandate say?

The debate on the ECB's 'green mandate' essentially revolves around the question of whether environmental sustainability forms part of the ECB's primary objective[33] or only of its supportive objectives.[34] The distinction between primary and supportive objectives is not easy to draw. Essentially, the primary and supportive objectives constitute two different ways of looking at the same thing: *the* (one) monetary mandate of the ECB. However, their distinction, even if somewhat artificial, offers an analytical framework to assess the implications for the ECB's policy actions: Under its primary objective, the ECB must take into account environmental aspects to contribute ultimately to maintaining price stability, not to environmental protection as such.[35] Contributing to environmental protection as such is a supportive objective, which the ECB must pursue, with the instruments and tools it has at hand, unless by pursuing that objective it would violate its primary objective of price stability.

The explicit reference to environmental protection in the ECB's supportive objectives has only recently attracted the ECB's attention. In the first relatively quiet years of its existence, the ECB had largely neglected its supportive objectives. The Great Financial Crisis (GFC), euro crisis and recent outbreak of the COVID-19 pandemic, however, laid bare the inaccuracy of the

[33] TFEU Article 127(1), first sentence.

[34] TFEU Article 127(1), second sentence; TEU Article 3(3), second sentence. The often-used term 'secondary objective' may be misleading in that the ECB is legally bound by *both* objectives.

[35] TFEU Article 11 (supporting this conclusion). See Javier Solana, 'The power of the Eurosystem to promote environmental protection' (2019) 30 European Business Law Review 547.

previously widely held assumption that the ECB's monetary policy mandate could be clearly and narrowly delineated from other economic policies in the EU. Just like other Central Banks have done repeatedly throughout history,[36] the ECB has taken forceful action to counteract economic developments that are bound to ultimately threaten the core of its mandate: price stability. It has done so by reference to its primary objective and without explicitly invoking its supportive objectives. However, the supportive objectives require the ECB's attention to systemic distributional and intergenerational challenges as far as its policies can make a significant impact and continue to give precedence to the primary objective in case of real trade-offs.

In the assessment and management of potential trade-offs between the objectives of price stability and environmental sustainability the ECB enjoys a wide margin of discretion. The GFC, which highlighted the merits of a monetary policy that 'leans against the wind' to safeguard financial stability in the short term, while ultimately maintaining price stability, may be instructive also in the present context. The application of a certain inter-temporal flexibility might well allow for monetary policy to help 'unlock and reinforce the winds' by facilitating the transition to an environmentally sustainable economy without losing sight of price stability in the medium to longer term.

[36] See Rens van Tilburg and Aleksandar Simić, 'Every avenue available – Lessons from monetary history for tackling climate change' (2021) Sustainable Finance Lab Report, sustainablefinancelab.nl/en/every-avenue-available-lessons-from-monetary-history-for-tackling-climate-change.

A straightforward reading of Article 127(1) TFEU[37] indeed implies that the ECB is *obligated* to support the general policies in the EU with a view to contributing to environmental protection.[38] In practical terms, this means that the ECB must explain and justify its monetary policy measures and decisions with a view not only to its primary objective, but also to its supportive objectives. Deeper analysis of the channels of effect and consideration of environmental side effects must guide the choice and design of monetary policy measures going forward. Or in legal terms: it may be disproportionate for the ECB to ignore environmental considerations by pursuing a narrowly defined objective of price stability at all costs.

The Treaties do not rank the supportive objectives in a specific order, suggesting that the ECB must, in principle, contribute to all of them equally. If the ECB does give preference to one supportive objective over the others, it must justify such preference, in particular by reference to a prioritization in the policies adopted by the EU.[39] This is a direct implication of the fact that the ECB acts in a supportive capacity here: Outside the immediate realm of price stability, the ECB is bound by the policy priorities identified by the competent and democratically accountable EU legislators. In light of the collective agreement

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[37] 'Primary' objective suggests that there are further objectives that must be observed, even if 'without prejudice to the primary objective'. Moreover, the term 'shall' implies that the ECB is obligated, rather than just empowered, to support the general economic policies in the EU.

[38] See also György Várhelyi, 'EU Taxonomy and the monetary policy prism' in European Central Bank (ed), *ESCB Legal Conference 2020* (European Central Bank 2021) 151, 154.

[39] See also Willem Bovenschen and René Lieshout, 'EU Taxonomy, action plan & supervisory developments on sustainable finance: what uses may these have for the E(S)CB?' in European Central Bank (ed), *ESCB Legal Conference 2020* (European Central Bank 2021) 125, 131.

of the Commission, European Parliament and Council on the need to forcefully counteract climate change, including by binding GHG reduction targets, such policy priority indeed exists with a view to climate change mitigation. Based on independent decisions, in particular regarding the alignment with the objective of price stability, and with the instruments and tools it has available, the ECB must support the mutually agreed climate policies of the EU on the basis of Article 127(1) TFEU. It must not, however, set environmental policies of its own.[40]

Less clarity exists regarding the extent to which environmental sustainability forms an implicit part of the ECB's primary objective. For good reasons, there appears to be increasing acknowledgement – also from within the ECB –[41] that the ECB may also fail to deliver on its price stability (and financial stability) objective if it ignores environmental sustainability considerations. While we are still improving our understanding of how environmental risks are impacting the economy and the financial system, price stability and environmental sustainability are mutually reinforcing objectives – at least in the longer term. Price stability is a precondition for environmental policies to bear fruit. Stable nominal prices enable the market to correctly interpret relative price signals. Simultaneously, timely and forceful mitigation policies will limit long lasting (and at least in part irreversible) effects of

[40] See TFEU Article 192.

[41] Isabel Schnabel, 'Never waste a good crisis: COVID-19, climate change and monetary policy' (speech at the INSPIRE virtual roundtable 'Sustainable Crisis Responses in Europe', 17 July 2020), ecb.europa.eu/press/key/date/2020/html/ecb.sp200717~1556b0f988.en.html; Christine Lagarde, 'Climate change and central banking' (keynote speech at the ILF conference on 'Green Banking and Green Central Banking', 25 January 2021) ecb.europa.eu/press/key/date/2021/html/ecb.sp210125~f87e826ca5.en.html.

environmental degradation on economic growth as well as other important monetary policy variables. Under scenarios of insufficient mitigation, the ability of the ECB to react to business cycle fluctuations as well as monetary transmission will likely be impaired. These threats become increasingly quantifiable within the medium term and thus of direct relevance for the inflation target underlying the ECB's price stability objective as determined by the Governing Council.[42]

3.2. Greening monetary policy: what can the ECB do to support the green recovery?

Its mandate allows and also requires the ECB to take into account environmental sustainability considerations when conducting monetary policy. Yet, how could the objective of environmental sustainability concretely translate into the ECB's monetary policy measures? Efforts to green the ECB's monetary policy will likely center around two elements of the toolkit: (1) the collateral framework as well as other conditions under which the ECB conducts monetary policy credit operations; and (2) the outright Eurosystem asset purchases.

The ECB and the National Central Banks are empowered to conduct credit operations with credit institutions and other market participants, provided that lending is based on adequate collateral.[43] The adequate collateral requirement aims to prevent the Eurosystem from incurring any losses in its monetary policy operations and to ensure the effectiveness of monetary transmission.[44] To green its collateral framework, the ECB

[42] Varhelyi (n 38) 154.
[43] ECB Statute, Article 18.1. The notion of 'adequate collateral' is not defined in the Treaties, but left to the Governing Council to define.
[44] Varhelyi (n 38) 160.

could include in its collateral base green assets that do not otherwise fulfil all eligibility criteria for Eurosystem collateral. As of 1 January 2020, for example, the Eurosystem accepts bonds with coupon structures linked to sustainability development targets.[45] Another proposal suggests giving preferential treatment to green assets, in terms of eligibility and/or haircuts applied, so as to counteract the existing carbon bias in the Eurosystem's collateral framework and reduce the cost of capital for low-carbon sectors compared to high-carbon sectors.[46] The difficulty here is to strike a balance between fostering the greenness of the collateral framework and risk management considerations. Their greenness does not necessarily imply that assets entail less credit risk and will benefit from enhanced liquidity in liquidation.

By initiating green TLTROs, the ECB would apply a preferential interest rate to banks that engage in green lending.[47] This proposal builds upon the logic of the green recovery: The provision of cheap funding to banks should incentivize them to support not just any, but primarily green economic activity. While operationally challenging to implement, green TLTROs have a high potential of making a direct economic impact. At the same time, they will directly affect the functioning of the

[45] Guideline (EU) 2020/1690 of the ECB of 25 September 2020 amending Guideline (EU) 2015/510 on the implementation of the Eurosystem monetary policy framework (ECB/2020/45) [2020] OJ L379/77 (according to the Governing Council's assessment, these bonds have a different risk profile than bonds whose coupon step-up is linked to a credit rating downgrade).

[46] Yannis Dafermos et al., 'Eurosystem collateral framework – How to decarbonize the ECB's monetary policy' (2021) The New Economics Foundation, neweconomics.org/uploads/files/Collateral-Framework.pdf.

[47] See Jens van't Klooster and Rens van Tilburg, 'Targeting a sustainable recovery with Green TLTROs' (2020) Positive Money Europe, positivemoney .eu/wp-content/uploads/2020/09/Green-TLTROs.pdf.

‘conventional’ monetary transmission mechanism − a fact that will undoubtedly impact the proportionality assessment.

Much at the forefront of the debate is a potential greening of the outright asset purchases. The Eurosystem is already buying green bonds under the APP (and the PEPP), but its purchases expressly continue to be guided by the principle of market neutrality and ‘[do] not positively or negatively discriminate on the basis of environmental or any other criteria’.[48] Accordingly, the ECB’s holdings of green eligible bonds ‘mirror […], by and large, the share of [its] holdings of the entire eligible universe’.[49] Empirical evidence shows that this approach creates a significant carbon bias in the asset portfolios of the ECB.[50] As environmental risks continue to be mispriced due to multiple market failures,[51] strict adherence to the market neutrality principle seems futile, if not counterproductive. This principle is often wrongly conflated with the principle of an open market economy, which is enshrined in the Treaties.[52] The Treaties, however, do not contain nor support a general

48 Roberto A De Santis et al., ‘Purchases of green bonds under the Eurosystem’s asset purchase programme’ (2018) 7 ECB Economic Bulletin 21.

49 Benoît Cœuré, ‘Monetary policy and climate change’ (speech at a conference on ‘Scaling up Green Finance: The Role of Central Banks’, 8 November 2018), bis.org/review/r181109f.htm.

50 See e.g. Dirk Schoenmaker, ‘Greening monetary policy’ (2019) Bruegel Working Paper, bruegel.org/2019/02/greening-monetary-policy; Sini Matikainen et al., ‘The climate impact of quantitative easing’ (2017) Grantham Research Institute on Climate Change and the Environment Policy Paper, lse.ac.uk/granthaminstitute/publication/the-climate-impact-of-quantitative-easing.

51 Isabel Schnabel, ‘When markets fail – the need for collective action in tackling climate change’ (speech at the European Sustainable Finance Summit, 28 September 2020), ecb.europa.eu/press/key/date/2020/html/ecb.sp200928_1~268b0b672f.en.html.

52 TFEU Articles 119(1) and (2) and 127(1).

requirement for the Eurosystem, or any other EU institution, to remain market neutral.[53] Such requirement would defeat any attempt to correct for market failures – the very justification for many public policy measures. The premise of the principle of an open market economy is that it favours 'an efficient allocation of resources'.[54] In the face of dysfunctional market pricing mechanisms, however, this premise no longer holds.[55] In any case, the Treaties allow for well-justified interference with the principle of an open market economy. Hence, monetary policy measures to counteract existing biases may well be necessary and proportionate in that their benefits for price stability may outweigh the costs for an open market economy. In fact, one may even argue that the principle of an open market economy with its three 'pillars' – open markets, free competition and efficient resource allocation – positively obliges the Eurosystem to green its monetary policy.[56]

A more fundamental critique of the self-imposed market neutrality principle points to the fact that the ECB makes significant choices when it pursues the objective of price stability and that these choices have distributive effects – even more so with the onset of unconventional monetary policy operations.[57] In other words, monetary policy naturally creates

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[53] See also Varhelyi (n 38) 162.
[54] TFEU Article 127(1).
[55] See Clovis Hopman, 'Monetary policy and the principle of an open market economy with free competition' in European Central Bank (ed), *ESCB Legal Conference 2018* (European Central Bank 2018) 36, 40.
[56] René Smits, 'Memo on monetary policy and climate change, biodiversity loss' (2021), renesmits.eu/wp-content/uploads/2021/03/Memo-on-monetary-policy-and-climate-change-biodiversity-loss_210221.pdf.
[57] See, e.g., Jens van 't Klooster and Clément Fontan, 'The myth of market neutrality: A comparative study of the European Central Bank's and the Swiss National Bank's corporate security purchases' (2020) 25 New Political Economy 865.

(unintended) side effects with winners and losers. Interestingly, and somewhat paradoxically, this critique is much in line with the *Weiss* ruling of the German Bundesverfassungsgericht (BVerfG).[58] It asks for the ECB to be more conscious and open about the side effects of monetary policy, including those it creates with a view to environmental sustainability, and to include them in a well-explained proportionality assessment.

When greening its monetary policy, the ECB will need to make choices in the design and use of monetary policy tools and instruments that privilege activities which are considered sustainable over activities considered unsustainable. But how to define and operationalize 'environmental sustainability' for monetary policy purposes? The Taxonomy Regulation[59] could be a starting point,[60] but other approaches are possible as well.[61] What matters is that the ECB's approach is aligned with the policy objectives and targets defined by the EU legislators. Only such alignment will avoid that the ECB makes environmental policy of its own.

4. Conclusion

The COVID-19 pandemic is only the last in a row of large-impact economic and societal events to demonstrate that monetary policy is no longer the boring exercise it was once perceived to be. It has necessitated decisive action from the ECB to stabilize markets and protect the credit supply along

[58] Judgment of the Second Senate of 5 May 2020, 2 BvR 859/15.
[59] Regulation (EU) 2020/852 of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 [2020] OJ L198/13.
[60] See Arruga Oleaga (n 11) 114, 115.
[61] Schoenmaker (n 50) proposes to use the average carbon intensity for each sector to tilt the ECB's direct asset holdings towards low-carbon sectors.

with measures initiated by fiscal and political authorities. Containment policies adopted in response to the pandemic-induced economic fallout are a prime example of how monetary and fiscal policies, if well-coordinated, have the potential to reinforce each other.

The pandemic crisis is also illustrative of the fact that action and inaction of the ECB have profound implications for financial markets. How financial actors think about risks is very much shaped by the ECB and the signals it sends. The increasing acknowledgment of the broader impact of contemporary monetary policy gives additional impetus to the discussion on the ECB's role in the economic recovery and, in particular, in all the structural changes the recovery entails with a view to achieving the goal of a net zero economy by 2050. Clear is that the ECB must not engage in environmental policymaking and that its role is of a catalysing and amplifying nature. The ECB's policies should align with and complement net zero transition plans produced by the competent and democratically accountable political authorities, rather than replacing action of these primarily responsible actors.

However, such alignment is still out of sight. Evidence shows that the ECB's monetary policy credit operations and asset purchase programmes are skewed towards carbon-intensive industries. There is an urgent need to bring these policies in line with established EU environmental policies, including the collectively agreed GHG reduction targets. Unless demonstrably necessary and proportionate to maintain price stability, monetary policy must not work against other economic policies in the EU[62] – in particular, if these policies

[62] TFEU Article 7.

are well-established, fleshed out and prioritized by the competent policymakers as is the case with a view to the urgency of tackling climate change. While making price stability the primary objective of the ECB, the Treaty drafters were well aware that the ECB can and should not operate in isolation.[63] The ECB's supportive objectives testify to that.

Over the coming years, the Commission aims to issue green bonds in the amount of EUR 225 billion under the Next Generation EU RFF. These bonds meet the eligibility criteria of both the ECB's collateral framework and the PSPP and PEPP.[64] The European Investment Bank has a long history of issuing green bonds and accounts already for a relatively large share of the total issuance of PSPP-eligible green bonds. Under its Group Climate Bank Roadmap, it is set to support EUR 1 trillion in investment for climate action and environmental sustainability until 2030. The greening of the ECB's policy might well be underway.

[63] See Draft Statute of the European System of Central Banks and of the European Central Bank ECB Statute N 1669/1670 (8 December 1990) 3, ecb.europa.eu/ecb/access_to_documents/document/cog_pubaccess/shared/data/ecb.dr.parcg2007_0005draftstatute.en.pdf. The BVerfG, without further elaboration, refers to a similar argument by the CJEU as 'flawed': BVerfG, Urteil vom 05. May 2020 – 2 BvR 859/15, para 142.
[64] Varhelyi (n 38) 164.

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9. The implementation of the single monetary policy since the outbreak of the pandemic crisis and some considerations on its impact on financial stability*

Christos V. Gortsos

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1. Introductory remarks

Since the start of Stage Three of the Economic and Monetary Union (EMU), on 1 January 1999, the European Central Bank (ECB) within the Eurosystem has been empowered 'to define

*The author wishes to thank Lambros Anastasopoulos for his valuable contribution to the documentation of this paper. The cut-off date for information included therein is 9 June 2021.

and implement the monetary policy of the Union', which is the first of its basic tasks in accordance with Article 127(2) first indent of the Treaty on the Functioning of the European Union[1] (TFEU) and the relevant provisions of the Statute of the European System of Central Banks (ESCB) and of the ECB[2] (the ESCB/ECB Statute).

Due to onset of the pandemic crisis, economic activity across the euro area was expected to inevitably suffer a considerable contraction. Considering that, the ECB adopted, since early 2020, profound monetary policy, liquidity-supporting measures (designed as temporary ones and close to those taken by major central banks all over the world). It applied both its conventional (interest rate) and unconventional (mainly, balance-sheet) policy.

These measures were aimed at both preserving the smooth provision of credit to the economy *and* ensuring that all its sectors can benefit from supportive financing conditions designed to absorb the implications of the crisis. They were adopted with a view to ensuring the Eurosystem's primary objective of price stability[3] and the proper functioning of the transmission mechanism of monetary policy effects on the level

[1] Consolidated version of the Treaty on European Union and the Treaty of the Functioning of the European Union [2016] OJ C 202/47.
[2] Protocol (No 4) on the Statute of the European System of Central Banks and of the European Central Bank [2016] OJ C 202/230.
[3] TFEU Article 127(1), first sentence; that reference to this primary objective is also made in Articles 119(2)-(3), 219(1)-(2) and 282(2), second sentence TFEU. In this respect, in December 1998, the Governing Council (GC) of the ECB adopted the following definition: 'Price stability is defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below, but close to, 2%'. According to this definition, price stability *shall be maintained over the medium term* (a precondition for sustained growth).

of prices (or 'monetary policy transmission mechanism'). [4] The ECB's goal was to counter the serious risks to the euro area economic outlook, taking into account the proportionality benchmark, as well as the limitations set by the TFEU (for example, the monetary financing of fiscal policy through the purchase of government bills and bonds in the primary market is prohibited by virtue of Article 123), and making use of the instruments at its disposal.

The monetary policy measures taken can be classified into three groups.

The *first* mainly relates to amendments made to some ECB key legal acts governing the general monetary policy framework of the Eurosystem,[5] namely: Guideline 2014/528/EU on additional temporary measures relating to Eurosystem refinancing operations and eligibility of collateral (…);[6] (the General Documentation) Guideline 2015/510 on the implementation of the Eurosystem monetary policy framework,[7] which (mainly

[4] For a detailed discussion on this mechanism, see European Central Bank, 'The Monetary Policy of the ECB' (2011) 59; Klaus Tuori, 'Monetary Policy (Objectives and Instruments)' in Fabian Amtenbrink and Christoph Herrmann (eds), *EU Law of Economic and Monetary Union* (Oxford University Press 2020) 624-626; Christos V. Gortsos, 'Legal Aspects of the Single Monetary Policy in the Euro Area: From the establishment of the Eurosystem to the current pandemic crisis' (2021), 18-19, ssrn.com/abstract=3819726.

[5] On this framework, see Christos V Gortsos, *European Central Banking Law* (Palgrave Macmillan Studies in Banking and Financial Institutions edn, Palgrave Macmillan, Cham 2020), 286-297; and Gortsos (n 4) 23-35 (with extensive further references).

[6] Guideline 2014/528/EU of the European Central Bank of 9 July 2014 on additional temporary measures relating to Eurosystem refinancing operations and eligibility of collateral and amending Guideline ECB/2007/9 (ECB/2014/31) OJ L 240/28.

[7] Guideline (EU) 2015/510 of the European Central Bank of 19 December 2014 on the implementation of the Eurosystem monetary policy framework

and *inter alia*) governs the so-called 'monetary policy operations' (i.e., open market operations and standing facilities);[8] Guideline 2016/65 on the valuation haircuts applied in the implementation of the Eurosystem monetary policy framework;[9] and Decision 2019/1311 on a third series of targeted longer-term refinancing operations (TLTRO-III); [10] it also relates to the introduction of the so-called 'pandemic emergency longer-term refinancing operations' (PELTROs) (see below, under 2).

The *second* group contains a new (and separate) Asset Purchase Programme (APP), the Pandemic Emergency Purchase Programme (PEPP) (see below, under 3.1). It also relates to amendments made to some pre-existing APPs, namely the third covered bond purchase programme (CBPP3), established by virtue of Decision 2014/828,[11] and the Corporate Sector

(ECB/2014/60) OJ L 91/3. By the end of May 2021, this legal act had been amended nine times.

[8] Guideline 2015/510, Article 2 (32); see below, under 2.1 and 2.2, respectively.

[9] Guideline (EU) 2016/65 of the European Central Bank of 18 November 2015 on the valuation haircuts applied in the implementation of the Eurosystem monetary policy framework (ECB/2015/35) OJ L 14/30.

[10] Decision (EU) 2019/1311 of the European Central Bank of 22 July 2019 on a third series of targeted longer-term refinancing operations (ECB/2019/21) OJ L 204/100. The ECB introduced the TLTROs in 2014 to reinforce the ECB's accommodative monetary policy stance and strengthen the transmission of monetary policy. The *first* series (TLTRO-I) was governed by 2014/541/EU Decision of the European Central Bank of 29 July 2014 on measures relating to targeted longer-term refinancing operations (ECB/2014/34) OJ L 258/11 (as in force) and the *second* series (TLTRO-II) by Decision (EU) 2016/810 of the European Central Bank of 28 April 2016 on a second series of targeted longer-term refinancing operations (ECB/2016/10) OJ L 132/ 107 (as in force).

[11] Decision 2014/828/EU of the European Central Bank of 15 October 2014 on the implementation of the third covered bond purchase programme (ECB/2014/40) OJ L 335/22.

Purchase Programme (CSPP), governed by Decision 2016/948[12] (see below, under 3.2).[13]

[12] Decision (EU) 2016/948 of the European Central Bank of 1 June 2016 on the implementation of the corporate sector purchase programme (ECB/2016/16) OJ L 157/28.

[13] The onset of the 2007-2009 Global Financial Crisis (GFC) and the euro area fiscal crisis (since 2010) (on these crises, see, by means of mere indication, Barry Eichengreen et al., *Public debts: nuts, bolts and worries*, vol 13 (Geneva Reports on the World Economy edn, International Center for Monetary and Banking Studies (ICMB) & Centre for Economic Policy Research 2011); Jay C. Shambaugh, *The Euro's Three Crises* (Brookings Papers on Economic Activity, 2012); Paul De Grauwe, 'Design Failures in the Eurozone: Can They Be Fixed?' (2013) LEQS Paper No 57, ssrn.com/abstract=2215762; Christos Hadjiemmanuil, 'The Euro Area in Crisis, 2008-18' in Amtenbrink and Hermann (n 4) showed that the key problem of concern to the ECB has not been the risk of inflation, but very low inflation. Given that, as already mentioned, the GC had defined price stability as a year-on-year increase in the HICP for the euro area of below, *but close to, 2%*, the fact that price levels remained persistently below this benchmark rendered necessary for the ECB, like other central banks around the world, to have recourse to quantitative easing (QE), containing 'unconventional' monetary policy instruments and mainly APPs. For an assessment, see Committee on the Global Financial System, 'Central bank operations in response to the financial turmoil' (2008) CGFS Papers No. 31, bis.org/publ/cgfs31.htm; European Central Bank, 'The ECB's monetary policy stance during the financial crisis' (2010) ECB Monthly Bulletin 63; Gregory Claeys, *The (not so) unconventional monetary policy of the European Central Bank since 2008* (European Parliament, Policy Department A: Economic Scientific Policy, 2014); European Central Bank, 'The Governing Council's Expanded Asset Purchase Programme' (2015) ECB Economic Bulletin 15; Chase P. Ross, Rosalind Wiggins and Andrew Metrick, 'European Central Bank Tools and Policy Actions A: Open Market Operations, Collateral Expansion and Standing Facilities' (2015) Yale Program on Financial Stability Case Study 2015-2A-V1, ssrn.com/abstract=2721873; 'European Central Bank Tools and Policy Actions B: Asset Purchase Programs' (2015) Yale Program on Financial Stability Case Study 2015-2B-V1 ssrn.com/abstract=2721470; Gregory Claeys and Alvaro Leandro, 'The European Central Bank's quantitative easing programme: Limits and risks' (2016) Bruegel Policy Contribution - Issue 2016/04; Chiara Zilioli and Phoebus L. Athanassiou, 'The European Central Bank' in Robert Schütze and Takis Tridimas (eds), *Oxford Principles*

The *third* group, finally, refers to the introduction of the Eurosystem repo facility for central banks (EUREP) and the reactivation of swap lines with several third country central banks (see, below under 4).

It is further noted that the key interest rates on the main refinancing operations (MROs), the marginal lending facility and the deposit facility, which have been set by the ECB, with effect from 18 September 2019, at 0%, 0.25% and -0.50%, respectively, remain since then unchanged.[14] This aspect is further discussed below, under 5.[15]

European Union Law – Volume I: The European Union Legal Order (Oxford University Press 2018) 633-644; Rene Smits, 'A central bank in times of crisis: the ECB's developing role in the EU's currency union' in Peter Conti-Brown and Rosa Maria Lastra (eds), *Research Handbook on Central Banking* (Edward Elgar Publishing 2018); Mario Draghi, 'Historical Lessons from the Euro Area Crisis for Monetary Policy' in Olivier Blanchard and Lawrence H. Summers (eds), *Evolution or Revolution? – Rethinking macroeconomic policy after the great recession* (The MIT Press 2019).

[14] The MROs are governed by Article 6 of Guideline 2015/510. For an overview of the characteristics of these operations, see also Table I of that Guideline. The marginal lending and the deposit facilities are governed by Articles 17-23 thereof.

[15] For a further analysis of (and documentation on) several of the aspects discussed in Sections 2-5 below, see also Pablo Hernández de Cos, 'The ECB monetary policy response to the pandemic crisis' (1st Ibero-American Central Bank Conference/ Banco de España andIbero-American General Secretariat); Drazen Rakic, *The ECB's Monetary Policy Response to the COVID-19 Crisis* (Directorate General for Internal Policies - Policy Department for Economic, Scientific and Quality of Life Policies, 2021); Luigi Bonatti, Andrea Fracasso and Roberto Tamborini, 'Unconventional Policy Instruments and Transmission Channels: A State-Contingent Toolbox for the ECB' in Drazen Rakic (ed), *Recalibrated Monetary Policy Instruments to Address the Economic Fallout from COVID-19* (Directorate General for Internal Policies - Policy Department for Economic, Scientific and Quality of Life Policies 2021). On the reaction of central banks on a global basis (in both advanced and emerging economies) as a response to the pandemic, see Bill English, Kristin Forbes, and Ángel Ubide, Monetary policy and central banking in the

2. Measures relating to the ECB general monetary policy framework

2.1. Decisions relating to the third series of targeted longer-term refinancing operations (TLTRO-III) and the pandemic emergency longer-term refinancing operations (PELTROs)

In order to support bank lending to SMEs during the crisis, the ECB adopted, on 16 March 2020, Decision 2020/407,[16] which amended four parameters of TLTRO-III: *first*, reduction (under conditions) of the interest rates applied to all TLTRO-III; *second*, increase of the borrowing allowance from 30% to 50%; *third*, modification of the maximum bid limit for individual such operations; and *fourth*, starting from September 2021, offer of an early repayment option for amounts borrowed under TLTRO-III, 12 (instead of 24) months after the settlement of each operation. To further support the provision of credit to households and firms, an additional temporary reduction in interest rates applied to all TLTRO-III was introduced by Decision 2020/614.[17] On the same date, the ECB also decided the conduct of pandemic emergency longer-term refinancing operations (PELTROs). By virtue of this new series of seven additional longer-term refinancing operations, liquidity support is provided to the euro area financial system to preserve the smooth functioning of money markets by providing an effective

Covid era: A new eBook (Vox EU and CEPR 2021), voxeu.org/article/monetary-policy-and-central-banking-covid-era-new-ebook.

[16] Decision (EU) 2020/407 of the European Central Bank of 16 March 2020 amending Decision (EU) 2019/1311 on a third series of targeted longer-term refinancing operations (ECB/2020/13) OJ L 80/23.

[17] Decision (EU) 2020/614 of the European Central Bank of 30 April 2020 amending Decision (EU) 2019/1311 on a third series of targeted longer-term refinancing operations (ECB/2020/25) OJ L 141/28.

backstop after the expiry of the bridge LTROs in force since March 2020.[18]

On 10 December, several terms and conditions of the TLTRO-III were further modified (*inter alia*, extension of the low interest rate period until June 2022, introduction of three additional operations and increase of the borrowing allowance to 55%). The modifications aimed at the preservation of the funding conditions that have supported credit institutions' efforts to keep providing credit for the real economy during the pandemic crisis.[19] On the same date, the PELTROs facility was extended by four additional operations on a quarterly basis during 2021.[20] It is also noted that on 7 January 2021, the European Securities and Markets Authority (ESMA) issued a Public Statement on the disclosures of significant accounting policies and judgements related to the third series of the TLTRO-III in the financial statements of credit institutions prepared in accordance with International Financial Reporting Standards (IFRS) Standards.[21]

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[18] See European Central Bank, 'ECB announces new pandemic emergency longer-term refinancing operations' (Press release, 30 April 2020), ecb.europa.eu/press/pr/date/2020/html/ecb.pr200430_1~477f400e39.en.html.

[19] Decision (EU) 2021/124 of the European Central Bank of 29 January 2021 amending Decision (EU) 2019/1311 on a third series of targeted longer-term refinancing operations (ECB/2021/3) OJ L 38/93.

[20] PELTROs are conducted as fixed rate tender procedures with full allotment. The interest rate is 25 basis points below the average rate applied in the Eurosystem's MROs (currently 0%) over the life of each respective PELTRO. See European Central Bank, 'ECB extends pandemic emergency longer-term refinancing operations' (Press release, 10 December 2020), ecb.europa.eu/press/pr/date/2020/html/ecb.pr 201210~8acfa5026f.en.html.

[21] ESMA, *ESMA promotes transparency regarding the accounting for the third series of the ECB's Targeted Longer-Term Refinancing Operations (TLTRO III)* (6 January 2021) ESMA32-339-149. On the overall role of the ESMA during the first phase of the pandemic crisis, see Niamh Moloney and Pierre-Henri Conac, 'EU Financial Market Governance and the Covid-19

Finally, on 30 April 2021, Decision 2019/1311 was modified yet again[22] to the effect that *first*, the sanctioning regime for TLTRO-III participants not providing required reports and audits in time was strengthened; and *second*, specific provisions were introduced regarding the treatment of corporate reorganisations occurring after 31 March for the purpose of calculating TLTRO-III interest rates.

Since the onset of the pandemic crisis, credit institutions resorted extensively to Eurosystem for liquidity through LTROs (including TLTRO-III) (from 616 billion euros in December 2019 to 2.1 trillion euros in May 2021[23]), while the amounts of MROs drastically declined. The use of the marginal lending facility was higher but limited.[24]

2.2. Implementation of the Eurosystem monetary policy framework and valuation haircuts

On 7 April 2020, the GC adopted Decision 2020/506,[25] which amended the above-mentioned Guidelines 2015/510 and 2016/65 to the following effect: *On the one hand*, the aim of the amendments to Guideline 2015/510 was to introduce temporary collateral easing measures to facilitate Eurosystem

Crisis: ESMA's Nimble, Responsive, and Speedy Response in Coordinating National Authorities through Soft-Law Instruments' (2014) 17 European Company and Financial Law Review 363.

[22] Decision (EU) 2021/752 of the European Central Bank of 30 April 2021 amending Decision (EU) 2019/1311 on a third series of targeted longer-term refinancing operations (ECB/2021/21) OJ L 161/1.

[23] See Table 1, asset item 5.2.

[24] See Table 1, asset items 5.1 and 5.3.

[25] Decision (EU) 2020/506 of the European Central Bank of 7 April 2020 amending Guideline (EU) 2015/510 on the implementation of the Eurosystem monetary policy framework and Guideline (EU) 2016/65 on the valuation haircuts applied in the implementation of the Eurosystem monetary policy framework (ECB/2020/20) OJ LI 109/1.

counterparties in maintaining sufficient eligible collateral. In this way, they would be able to participate in all liquidity-providing operations.[26] In particular, under the amended Article 93 (on the minimum size of credit claims), for domestic use, credit claims must, at the time of their submission as collateral by the counterparty, meet a minimum size threshold of 0 euros, or any higher amount laid down by the home national central bank (NCB) of the Member States whose currency is the euro.[27]

On the other hand, the amendments to Guideline 2016/65 were based on the ECB decision to temporarily increase its willingness to take on risks to support credit provision through its refinancing operations.[28] In particular, the valuation haircuts applied to collateral were reduced by a fixed factor as follows:[29]

First, further to the valuation haircuts laid down in Article 3, applicable are also the following *additional* valuation haircuts: a valuation markdown of 4% applies to asset-backed securities, covered bonds and unsecured debt instruments issued by credit institutions that are theoretically valued in accordance with the rules contained in Article 134 of Guideline 2015/510; and a valuation haircut of 6,4% or 9,6% (applied to the value of debt

[26] On the collateral framework of the Eurosystem before the pandemic crisis, also from a comparative point of view, see European Central Bank, *Collateral Eligibility Requirements – A Comparative Study across Specific Frameworks* (2013); and 'The Eurosystem collateral framework throughout the crisis' (2013) ECB Monthly Bulletin 71.

[27] In Article 141(1) of Guideline 2015/510, on the limits with respect to unsecured debt instruments issued by credit institutions and entities closely linked thereto, the percentage value of 2,5% was increased to 10% (Decision 2020/506, article 1).

[28] Decision 2020/506, recital (5).

[29] Decision 2020/506, Article 2(2) amending Article 5(5) of Guideline 2016/65.

instruments allocated to credit quality steps 1-2 or 3, respectively[30]) applies to 'own-use' covered bonds.[31]

Second, non-marketable retail mortgage-backed debt instruments are subject to a valuation haircut of 25.2%.

Guideline 2016/65 was further amended on 25 September 2020,[32] mainly with a view to replace Table 1 in the Annex on the haircut categories for eligible marketable assets based on the type of issuer and/or asset. Guideline 2015/510 was further amended as well, on 6 May 2021,[33] to give effect (from 28 June 2021) to the leverage ratio becoming a binding Pillar 1 own-funds requirement under the CRR.

[30] In order to be eligible, assets must meet the high credit standards specified in the 'Eurosystem credit assessment framework' (ECAF), which lays down the procedures, rules and techniques to ensure, primarily, that the Eurosystem's requirement for such standards is maintained and, secondarily, that these assets comply with the credit quality requirements defined by the Eurosystem in the form of credit quality steps by application of threshold values for the probability of default (PD) over a one-year horizon (Guideline 2015/510, Articles 59(1)-(3)). Additional credit quality requirements for marketable and non-marketable assets are applied by the Eurosystem in accordance with Articles 60-88 and 89-112.

[31] 'Own-use' covered bonds are those issued or guaranteed by the counterparty itself or by any other entity with which it has close links as determined pursuant to Article 138 of Guideline 2015/510.

[32] Guideline (EU) 2020/1692 of the European Central Bank of 25 September 2020 amending Guideline (EU) 2016/65 on the valuation haircuts applied in the implementation of the Eurosystem monetary policy framework (ECB/2020/46) OJ L 379/94.

[33] Guideline (EU) 2021/889 of the European Central Bank of 6 May 2021 amending Guideline (EU) 2015/510 on the implementation of the Eurosystem monetary policy framework (ECB/2021/23) OJ L 196/1.

2.3. Additional temporary measures relating to Eurosystem refinancing operations and to eligibility of collateral

With a view to mitigating the adverse impact on collateral availability of potential severe rating downgrades resulting from the pandemic, on 7 April 2020, the ECB adopted Guideline 2020/515.[34] This act amended the above-mentioned Guideline 2014/528 and laid down collateral easing measures, *inter alia*, by reducing the valuation haircuts applied to certain collateral assets. The purpose was to facilitate Eurosystem counterparties in maintaining and mobilising sufficient collateral to be able to participate in its liquidity-providing operations. Hence, participation in these operations is based on amended collateral eligibility criteria and risk control measures.[35]

Further to the above collateral easing measures, by virtue of Guideline 2020/634,[36] Guideline 2014/528/EU was further

[34] Guideline (EU) 2020/515 of the European Central Bank of 7 April 2020 amending Guideline ECB/2014/31 on additional temporary measures relating to Eurosystem refinancing operations and eligibility of collateral (ECB/2020/21) OJ LI 110/26.

[35] Guideline 2020/515, recitals (3)-(4). The GC also assessed the need to alleviate pressures stemming from the pandemic crisis on Greek financial markets, taking into account, *inter alia*, the commitments undertaken by the Hellenic Republic in the context of the enhanced surveillance pursuant to Regulation (EU) No 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability [2013] OJ L 140, the monitoring of its implementation by EU institutions, where the ECB is also involved, and the fact that the Hellenic Republic had regained market access (Guideline 2020/515, recital (5)).

[36] Guideline (EU) 2020/634 of the European Central Bank of 7 May 2020 amending Guideline ECB/2014/31 on additional temporary measures relating to Eurosystem refinancing operations and eligibility of collateral (ECB/2020/29) OJ L 148/10.

amended in order, *first*, to mitigate the adverse impact on Eurosystem collateral availability of potential rating downgrades resulting from the economic fallout of the pandemic crisis; and *second*, to ensure that Eurosystem counterparties remain able to maintain and mobilise sufficient collateral to be able to participate in its liquidity-providing operations. Accordingly, participation in these operations with collateral should be based on temporarily amended collateral eligibility criteria and risk control measures.[37] In this respect, the GC made three considerations.[38] *First*, marketable assets and their issuers that fulfilled minimum credit quality requirements on 7 April 2020 should temporarily continue to be admitted as collateral, despite a deterioration in the credit ratings decided by the credit rating agencies accepted in the Eurosystem, as long as the ratings remain above a certain quality level. *Second*, the eligibility criteria for outright purchases under the ECB's asset purchase programme (APP) should not be affected. *Third*, these measures will apply until the first early repayment date under the TLTRO-III to ensure an appropriate monetary policy transmission mechanism and, taking into account the need of Eurosystem counterparties that are, or will be, participating in its liquidity providing operations, to maintain sufficient collateral for these operations.

3. The asset purchase programmes

3.1. Establishment of the Pandemic Emergency Purchase Programme (PEPP)

On 24 March 2020, the ECB established a new Asset Purchase Programme (APP) by virtue of Decision 2020/440 on a

[37] Guideline 2020/634, recital (2).
[38] Guideline 2020/634, recitals (4)-(5).

temporary pandemic emergency purchase programme (PEPP).[39] This Programme of (initially) 750 billion euros is governed by the following:

First, Eurosystem central banks can, in principle, purchase the following types of 'eligible' assets:[40] marketable debt securities,[41] corporate bonds and other marketable debt

[39] Decision (EU) 2020/440 of the European Central Bank of 24 March 2020 on a temporary pandemic emergency purchase programme (ECB/2020/17) OJ L 91/1. On this program, *see* details in Sebastian Grund, 'The Legality of the European Central Bank's Pandemic Emergency Purchase Programme' (2020) Delors Institute Policy Brief ssrn.com/abstract=3558677; Rosa Maria Lastra and Kern Alexander, *The ECB Mandate: Perspectives on Sustainability and Solidarity* (Directorate General for Internal Policies - Policy Department for Economic, Scientific and Qulaity of Life Policies, 2020) (also briefly discussing some of the other recent monetary policy measures); Rene Smits, 'The European Central Bank's pandemic bazooka: mandate fulfilment in extraordinary times' (*EU Law Live*, 23 March 2020), eulawlive.com/op-ed-the-european-central-banks-pandemic-bazooka-mandate-fulfilment-in-extraordinary-times-by-rene-smits/#.

[40] Decision 2020/440, Article 1(2).

[41] These are governed by Decision (EU) 2020/188 of 3 February 2020 on a secondary markets public sector asset purchase programme [PSPP] (ECB/2020/9) OJ L *39/12, which repealed, according to Article 10(1),* Decision (EU) 2015/774 of the European Central Bank of 4 March 2015 on a secondary markets public sector asset purchase programme (ECB/2015/10) OJ L 121/20. On this programme, see Tuori (n 4) 675-686. In relation to the PSPP it is further noted that the validity of the relevant ECB Decision was contested before the German Federal Constitutional Court (FCC), which referred for a preliminary ruling to the Court of Justice of the EU (CJEU). The judgment of the latter in Case C-493/17 *Weiss and others* [2017] ECLI:EU:C:2018:1000 found no factor affecting the validity of the ECB Decision. On this case, see, by means of mere indication, Alicia Hinarejos, 'The Legality of Responses to the Crisis' in Amtenbrink and Hermann (n 4) 1376-1377; Michael Ioannides, 'The Judicial Review of Discretion in the Banking Union: from 'Soft' to 'Hard(er)' Look?' in Chiara Zilioli and Karl-Philipp Wojcik (eds), *Judicial Review in the European Banking Union* (Edward Elgar Publishing 2021) 144-145. Nevertheless, in its judgement of 5 May 2020 (FCC, Judgment of the Second Senate, 2 BvR 859/15, bundesverfassungsgericht.de/SharedDocs/Pressemitteilungen/EN/2020/bvg2

instruments,[42] covered bonds[43] and asset-backed securities (ABSs).[44]

Second, purchases are carried out to the extent deemed necessary and proportionate to counter the threats posed by the

0-032.html), the FCC declared the CJEU's judgement in the *Weiss Case* and the contested ECB Decisions *ultra vires*, as having violated EU law by failing to correctly apply the proportionality principle, and, thus, not applicable in Germany. On this latter judgement, see, by means of mere indication (out of an already vast literature), Fabian Amtenbrink and René Repasi, 'The German Federal Constitutional Court's Decision in Weiss: A Contextual Analysis' [2020] ELR 757; Lars P Feld and Volker Wieland, 'The German Federal Constitutional Court Ruling and the European Central Bank's Strategy' (2020) CEPR Discussion Paper No. DP15320, ssrn.com/abstract=3723509; Raffaele D'Ambrosio and Donato Messineo (eds), *The German Federal Constitutional Court and the Banking Union*, vol 91 (Banca d'Italia 2021).
It is noteworthy that on 9 June 2021, the Commission decided in this respect to send a letter of formal notice to Germany for violation of fundamental principles of EU law, in particular, the principles of autonomy, primacy, effectiveness and uniform application, as well as the respect of the jurisdiction of the CJEU under Article 267 TFEU, ec.europa.eu/commission/presscorner/detail/en/inf_21_2743.

[42] These are governed by the above-mentioned Decision 2016/948 on the implementation of the CSPP. In order to be eligible for purchase under the PEPP, marketable debt securities must have a minimum remaining maturity of 70 days and a maximum remaining maturity of 30 years at the time of their purchase. Instruments with a remaining maturity of 30 years and 364 days are eligible for the sake of facilitating smooth implementation (Decision 2020/440, Article 2). Euro-denominated marketable debt securities issued by the central government of the Hellenic Republic are eligible for purchases, if they comply with the purchase criteria as set out in Article 3(4) of that Decision.

[43] These are governed by Decision (EU) 2020/187 of the European Central Bank of 3 February 2020 on the implementation of the third covered bond purchase programme (ECB/2020/8) OJ L 39/6.

[44] These are governed by Decision (EU) 2015/5 of the European Central Bank of 19 November 2014 on the implementation of the asset-backed securities purchase programme (ECB/2014/45) OJ L 1/4.

extraordinary conditions on the Eurosystem's ability to fulfil its mandate.[45]

Third, the allocation of cumulative net purchases of marketable debt securities issued by eligible governments and recognised agencies across eligible jurisdictions of the euro area is guided, on a stock basis, by the respective NCBs' subscription to the ECB's capital (in accordance with Article 29 ESCB/ECB Statute). Purchases must be conducted in a flexible manner allowing for fluctuations in the distribution of (purchase) flows over time, across asset classes and among jurisdictions.[46]

Finally, the Eurosystem can make securities purchased under the PEPP available for lending, including repos, with a view to ensuring the effectiveness of the Programme.[47]

At its meeting of 4 June 2020, the GC decided to increase the PEPP's envelope to a total of 1.35 trillion euros with a view to further ease the general monetary policy stance. Purchases would continue to be conducted in a flexible manner over time, across asset classes and among jurisdictions. The horizon for net purchases under this Programme has been extended to the end of June 2021. The maturing principal payments from securities purchased under the PEPP will be reinvested until, at least, the end of 2022.[48] It was formalised in Decision

[45] For the sake of effectiveness, the consolidation of holdings in accordance with Article 5 of Decision 2020/188 does not apply to PEPP holdings (Decision 2020/440, Article 4).
[46] Decision 2020/40, Article 5(1)-(2). The purchase allocation may be adjusted to allow for fluctuations in the distribution of purchase flows, over time, across asset classes and among jurisdictions (Decision 2020/440 Article 5(3)).
[47] Decision 2020/440, Article 7.
[48] See European Central Bank, 'Monetary Policy Decisions' (Press Release, 4 June 2020) paras (1)-(3) ecb.europa.eu/press/pr/date/2020/html/ecb.mp200604~a307d3429c.en.html.

2020/1143,[49] by virtue of which the PEPP was established as a separate purchase programme, with an overall envelope of 1.35 trillion euros. The maturing principal payments from securities purchased under the PEPP shall be reinvested by purchasing eligible marketable debt securities until, at least, the end of 2022 and, in any case, the future roll-off of its portfolio shall be managed in such a way as to avoid interference with the appropriate monetary stance.[50] *Furthermore*, the GC delegated to the Executive Board the power to set the appropriate pace and composition of PEPP monthly purchases within the total overall envelope of 1.35 trillion euros. It can, thus, adjust the purchase allocation to allow for fluctuations in the distribution of purchase flows, over time, across asset classes and among jurisdictions.[51]

The ECB Decision adopting the PEPP was further amended on 10 February 2021 by Decision 2021/174,[52] which entered into force on 19 February. By virtue of this Decision, the overall separate envelope was further increased by 500 billion euros (to 1.85 trillion euros) and the horizon of net purchases under this Programme was extended until, at least, the end of March 2022 (and, in any case, until the ECB judges that the crisis phase is over).

[49] Decision (EU) 2020/1143 of the European Central Bank of 28 July 2020 amending Decision (EU) 2020/440 on a temporary pandemic emergency purchase programme (ECB/2020/36) OJ L 248/24.
[50] Decision 2020/1143, Article 1(1), replacing Article 1(1) of Decision 2020/440.
[51] Decision 2020/1143, Article 1(2), replacing Article 5(3) of Decision 2020/440.
[52] Decision (EU) 2021/174 of the European Central Bank of 10 February 2021 amending Decision (EU) 2020/440 on a temporary pandemic emergency purchase programme (ECB/2021/6) OJ L 50/29.

In accordance with the monetary policy decisions taken on 22 April 2021, purchases under the PEPP are conducted in a flexible way (over time, across asset classes and among jurisdictions) and according to market conditions, with a view to prevent a tightening of financing conditions that counters inconsistently the downward impact of the pandemic crisis on the projected path of inflation and to support the smooth transmission of monetary policy. Furthermore, the GC expects purchases under the PEPP over the current quarter to continue to be conducted at a significantly higher pace than during the first months of the year.[53]

3.2. Amendments to pre-existing asset purchase programmes (APPs)

The third covered bond purchase programme (CBPP3), established by Decision 2014/828, was recast by Decision 2020/187.[54] In accordance with the latter, even though covered bonds issued by credit institutions whose access to Eurosystem monetary policy operations has been limited, suspended or excluded pursuant to Guideline 2015/510 are also automatically excluded from purchases under this programme for the duration of the limitation, suspension or exclusion, the GC retains the power, following a case-by-case assessment, to reassess the exclusion of such covered bonds and to revoke the exclusion,

[53] ECB, 'Monetary policy decisions' (Press Release, 22 April 2021) paras (2)-(3), ecb.europa.eu/press/pr/date/2021/html/ecb.mp210422~f075ebe1f0.en.html.

[54] *This Decision* was then further amended by Decision (EU) 2020/1688 of the European Central Bank of 25 September 2020 amending Decision (EU) 2020/187 on the implementation of the third covered bonds purchase programme (ECB/2020/48) OJ L 379/58, *which applies from 1 January 2021*.

if deemed appropriate.[55] Furthermore, pursuant to Decision 2020/441,[56] which amended Decision 2016/948, the range of eligible assets under the CSPP was also extended to non-financial commercial papers, making all commercial papers of sufficient credit quality eligible for purchase thereunder.

3.3. Further Governing Council announcements relating to asset purchase programs (APPs)

In accordance with (*inter alia*) the GC announcements on 4 June and 10 December 2020 and on 11 March and 22 April 2021, net purchases under the APP continue at a monthly pace of 20 billion euros, expecting monthly net asset purchases to run for as long as necessary to reinforce the accommodative impact of its policy rates and to end shortly before it starts raising the key ECB interest rates. Reinvestments of the principal payments from maturing securities purchased under the APP will continue, in full, for an extended period of time, past the date when the GC starts raising the key ECB interest rates. In any case, they will continue for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.[57]

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[55] Decision (EU) 2020/187, Article 3 (3), as amended by Decision 2020/1688, Article 1.

[56] Decision (EU) 2020/441 of the European Central Bank of 24 March 2020 amending Decision (EU) 2016/948 of the European Central Bank on the implementation of the corporate sector purchase programme (ECB/2020/18) OJ L 91/5.

[57] See ECB, 'Monetary policy decisions' (Press Release, 10 December 2020) para (6), ecb.europa.eu/press/pr/date/2020/html/ecb.mp201210~8c2778b843.en.html; ECB, 'Monetary policy decisions' (Press Release, 11 March 2021) para (4), ecb.europa.eu/press/pr/date/2021/html/ecb.mp210311~35ba71f535.en.html; and ECB (n 53) para 5.

The amounts of securities of euro area residents denominated in euro held by the Eurosystem significantly increased again since the onset of the pandemic crisis (from 2.85 trillion euros in December 2019 to 4.3 trillion euros in May 2021[58]). Overall, the Eurosystem's consolidated balance sheet (further) increased from 4.67 trillion euros in December 2019 (4.14 trillion in April 2017) to 7.65 trillion euros in May 2021.

4. Introduction of the Eurosystem repo facility for central banks (EUREP) – swap lines and arrangements

On 25 June 2020, the GC set up a new 'backstop facility', called the Eurosystem repo facility for central banks (EUREP), to provide precautionary euro repo lines to central banks outside the euro area in exchange of adequate collateral (consisting of euro-denominated marketable debt securities issued by euro area central governments and supranational institutions).[59] This facility, which will be available until March 2022, *first*, addresses possible euro liquidity needs in case of market dysfunction resulting from the crisis that might adversely impact the smooth transmission of ECB monetary policy; and *second*, complements the ECB's bilateral swap and repo lines reflecting the importance of the euro in global financial markets. It is also noted that, since March 2020 (and *inter alia*), the ECB reactivated swap lines in US dollar with the US Federal

[58] See Table 1, asset item 7.
[59] See ECB, 'New Eurosystem repo facility to provide euro liquidity to non-euro area central banks' (Press Release, 25 June 2020), ecb.europa.eu/press/pr/date/2020/html/ecb.pr200625~60373986e5.en.html. By means of indication, repo line arrangements have been concluded with the National Bank of Romania, the Hungarian National Bank, the National Bank of Serbia, the Bank of Albania and the National Bank of North Macedonia.

Reserve System,[60] as well as the swap arrangements with the Danish National Bank and the People's Bank of China and established temporary precautionary swap lines with Croatia and Bulgaria.

5. Developments in relation to interest rates

As already noted in Section 1 above, the key interest rates on the MROs,[61] the marginal lending facility and the deposit facility, remain unchanged, since 18 September 2019, at 0%, 0.25% and -0.50%, respectively. In this respect and taking into account the fact that the euro area economy was facing (for the first time since May 2016) deflation (during the period August - December 2020, *max* at -0.3%),[62] the GC repeatedly announced that it 'expects them to remain at these or even lower levels until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its

[60] When, during the GFC, funding markets dried up because of an extreme aversion to risk and it became difficult for euro area credit institutions to obtain US dollars to fund their USD-denominated assets, in order to prevent disruptions, the ECB and the US Federal Reserve System set up a currency swap line, allowing the Eurosystem to provide US dollars to credit institutions located in the euro area. See European Central Bank, 'What are currency swap lines?' (*European Central Bank – Explainer*, 27 September 2016 and updated on 30 April 2021), ecb.europa.eu/explainers/tell-me-more/html/currency_swap_lines.en.html.

[61] This is the benchmark ECB rate.

[62] See European Central Bank, 'Measuring inflation – the Harmonised Index of Consumer Prices (HICP)' (*European Central Bank – Macroeconomic and sectoral statistics)*, ecb.europa.eu/stats/macroeconomic_and_sectoral/hicp/html/index.en.html. Since early 2021, nevertheless, inflation is again into positive territory (2.0% in May).

projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics'.[63]

The existence of negative deposit facility rates since mid-2014 has not disincentivised credit institutions from having recourse to this standing facility.[64] In particular, the amounts of this facility totalled 623.4 billion euros in December 2017. They declined substantially to 275.7 billion euros in December 2019. In December 2020, they increased again exponentially at the level of 683.9 billion euros and further increased to 758.9 billion euros in May 2021.[65]

Two exceptional provisions deserve reference in this context: *First*, exempt from negative interest rates are, by virtue of Decision 2020/1264,[66] the funds mandatorily deposited with the ECB for the purpose of repaying financial assistance under Council Regulation 2020/672 (governing the SURE

[63] See, *inter alia*, ECB (Press release, 10 December 2020, n 57) para (6); ECB (Press Release, 11 March 2021, n 57) para (6); and ECB (Press Release, 22 April 2021, n 57) para (1).
[64] The interest rate applied to the deposit facility may be positive, set at 0%, or be negative (Guideline 2015/510, Article 21(3)). The application of negative interest rates is not provided either for MROs and LTROs or for the marginal lending facility (Articles 6 and 18). Exceptionally, the interest rates applied to fixed-term deposits for the purpose of fine-tuning operations may also be negative (Article 12(3)).
[65] See Table 1, liability item 2.2.
[66] Decision (EU) 2020/1264 of the European Central Bank of 8 September 2020 amending Decision (EU) 2019/1743 of the European Central Bank on the remuneration of holdings of excess reserves and of certain deposits (ECB/2020/38) OJ L 297/5.

instrument).[67] *Second*, by virtue of ECB Decision 2021/874,[68] deposits held in ECB accounts in advance of the date on which a payment must be made in accordance with the legal or contractual rules applicable to a relevant facility shall be remunerated during this advance period at 0% or the deposit facility rate, whichever is higher. The same applies, in principle, for the dedicated account maintained with the ECB in accordance with Article 13(2) of Commission Implementing Decision 2021/611[69] establishing the necessary arrangements for the administration of the *borrowing operations* under Council Decision 2020/2053,[70] and for the *lending operations* related to loans granted in accordance with Article 15 of Regulation 2021/241 establishing the Recovery and Resilience Facility[71] (RRF) for the purposes of prudential cash holdings as referred to in that Article. Exceptionally, if the aggregate amounts of deposits held in that account exceed 20 billion

[67] Council Regulation (EU) 2020/672 of 19 May 2020 on the establishment of a European instrument for temporary support to mitigate unemployment risks in an emergency (SURE) following the COVID-19 outbreak [2020] OJ L 159.

[68] Decision (EU) 2021/874 of the European Central Bank of 26 May 2021 amending Decision (EU) 2019/1743 on the remuneration of holdings of excess reserves and of certain deposits (ECB/2021/25) OJ L 191/43.

[69] Commission Implementing Decision (EU) 2021/611 of 14 April 2021 amending Implementing Decision (EU) 2020/438 as regards harmonised standards on biological evaluation of medical devices, packaging for terminally sterilised medical devices, sterilisation of health care products and clinical investigation of medical devices for human subjects (C/2021/2434) OJ L 129C (2021) 2502 final.

[70] Council Decision (EU, Euratom) 2020/2053 of 14 December 2020 on the system of own resources of the European Union and repealing Decision 2014/335/EU, Euratom [2020] OJ L 424.

[71] Regulation (EU) 2021/241 of the European Parliament and of the Council of 12 February 2021 establishing the Recovery and Resilience Facility [2021] OJ L 57.

euros, the amount in excess shall be remunerated at the deposit facility rate.[72]

Furthermore, interest rates in the interbank market are currently negative as well. In particular, in June 2021, the euro overnight index average (EONIA) was ranging from -0.478% (for daily lending) to -0.479% (for monthly lending), and to -0.481 (for yearly lending, as of April).[73] This is considered a positive development with regard to the effectiveness of the single monetary policy and the appropriate (partly, at least) functioning of the transmission mechanism. As noted by Schnabel:[74]

'After the [deposit facility rate] was lowered into negative territory, the entire 3-month Euribor forward curve shifted down further and eventually traded fully in negative territory, and it even started to exhibit a slight inversion. In other words, the ECB had succeeded in shifting the perceived lower bound on interest rates firmly into negative territory, supported by forward guidance that left the door open for the possibility of further rate cuts. This restored a fundamentally important element of monetary policy: the possibility for the market to

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[72] Pursuant to recital (3) of Decision (EU) 2021/874, in accordance with Article 22 of the Commission Implementing Decision 2021/611, the borrowing, debt management and lending operations of the RRF will not be implemented until the date of entry into force of Council Decision 2020/2053. However, as such borrowing, debt management and lending operations are expected to commence in June 2021, it is necessary to prepare the ECB legal framework for such implementation before the date of entry into force of that Council Decision, to provide for such exemptions.

[73] See 'Eonia' (*Euribor Rates*), euribor-rates.eu/en/eonia.

[74] See ECB, 'Going Negative: the ECB's experience' (Speech by Isabel Schnabel, Member of the Executive Board of the ECB, at the Roundtable on Monetary Policy, Low Interest Rates and Risk Taking at the 35th Congress of the European Economic Association, 26 August 2020), ecb.europa.eu/press/key/date/2020/html/ecb.sp200826~77ce66626c.en.html.

anticipate further policy cuts and to thereby frontload policy accommodation. The zero lower bound was no longer constraining market expectations'.

6. Some considerations relating to the impact on financial stability

Under the extraordinary circumstances arising from the need to bolster the banking (and, more generally, financial) system following the GFC (and, in the European context, the subsequent fiscal crisis in the euro area), central banks all over the world, including the ECB, adjusted their monetary policy.[75] The fact that price levels remained persistently below the benchmark set for price stability and central bank interest rates came close to their effective lower bound (the point at which lowering them further would have little to no effect), rendered necessary for central banks to have recourse to 'balance sheet policies' (QE), containing 'unconventional' monetary policy instruments,[76] including the implementation of APPs.[77]

[75] See, on this, Claudio Borio and William Nelson, 'Monetary Operations and the Financial Turmoil' (2008) BIS Quarterly Review; the various contributions in Bank for International Settlements, 'The future of central baking under post-crisis mandates' (2011) BIS Papers No 55.

[76] On this, see Claudio Borio and Piti Disyatat, 'Unconventional Monetary Policies: An Appraisal' (2009) BIS Working Papers No 292; Jaime Caruana, 'Why central bank balance sheets matter' (Keynote address at the Bank of Thailand – BIS conference on Central bank balance sheets in Asia and the Pacific: the policy challenges ahead, 2011); Alain Durré and Huw Pill, 'Central Bank balance sheets as policy tools' (2012) BIS Papers No 66 193; Ben S Bernanke, 'Monetary Policy in a new Era' in Blanchard and Summers (n 13).

[77] Asset purchases under such programmes influence broader financial conditions and, eventually, economic growth and inflation, through three main channels: the 'direct pass-through', 'portfolio rebalancing' and a 'signalling effect'. See European Central Bank, 'How does the ECB's asset

Furthermore, central banks are keeping their key interest rates at (unprecedentedly) low levels. After a prolonged period of persistently low interest rates (a 'liquidity trap' situation)[78], however, which is lasting even longer due to the current pandemic crisis, as discussed above, a major policy challenge is to limit the financial excesses resulting from accommodative monetary policies. By managing the resulting negative financial impact, repeating one of the main causes of the GFC can be avoided.[79] *Inter alia*,[80] a territory of negative deposit facility rates has significant negative impact on credit institutions' profitability, taking account of the fact that they face (legal or business-oriented) limitations on passing on negative rates (in particular) to their retail depositors.[81]

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purchase programme work?' (*European Central Bank – Explainers*, 22 January 2016 and updated on 28 February 2019), ecb.europa.eu/explainers/tell-me-more/html/app.en.html.

[78] According to Keynes: 'There is the possibility (...) that, after the rate of interest has fallen to a certain level, liquidity-preference may become virtually absolute in the sense that almost everyone prefers cash to holding a debt which yields so low a rate of interest. In this event the monetary authority would have lost effective control over the rate of interest. But whilst this limiting case might become practically important in future, I know of no example of it hitherto'. See John Maynard Keynes, *The General Theory of Employment, Interest and Money* (Palgrave Macmillan 1936).

[79] On the causes and consequences of persistently low interest rates, see, by means of indication, Charles Bean et al., 'Low for Long? Causes and Consequences of Persistently Low Interest Rates' (2015) Geneva Reports on the World Economy 17 Laurence Ball et al., 'What Else Can Central Banks Do?' (2016) Geneva Reports on the World Economy 18 (both with extensive further references); as Blanchard and Summers (n 13) xxviii – xxvi.

[80] For an analytical overview of the various transmission links between monetary policy and financial stability, see the various contributions in Bank for International Settlements, Monetary stability, financial stability and the business cycle: five views' (2003) BIS Papers No 18, as well as IMF, *Monetary Policy and Financial Stability* (2015).

[81] See Carlo Altavilla et al., 'Is there a zero lower bound? The Effects of Negative Policy Rates on Banks and Firms' (2021) Swedish House of Finance

In this respect it is noteworthy that on 23 January 2020 the GC launched a review of the Eurosystem's monetary policy strategy,[82] which was expected to be concluded by end-2020, but this deadline was extended to mid-2021 due to emergency situation resulting from the pandemic crisis.[83] This review contains five pillars concerning the following aspects:[84] the precise definition of price stability, including the inflation rate's target level; the way the economic and monetary analyses are conducted; the relevance of issues such as employment, social inclusion, climate change and financial stability in pursuing the Eurosystem's mandate;[85] the monetary policy instruments used,

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Research Paper No. 19-11; Florian Heider, Farzad Saidi and Glenn Schepens, 'Life below Zero: Bank Lending under Negative Policy Rates' 32 The Review of Financial Studies 3728; Schnabel (n 74).

82 In 2019, the US Federal Reserve launched its own comprehensive and public review of the monetary policy framework employed to achieve its congressionally mandated goals of maximum employment and price stability and better meet future challenges. See Board of Governors of the Federal Reserve System, '2019-2020 Review of Monetary Policy Strategy, Tools, and Communications' (*Federal* Reserve, August 2020), federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications.htm.

83 See ECB, 'ECB extends review of its monetary policy strategy until mid-2021' (Press Release, 2 April 2020), ecb.europa.eu/press/pr/date/2020/html/ecb.pr200402~942a1358ee.en.html.

84 See ECB, 'Questions and Answers on the Strategy Review' (*European Central Bank*), ecb.europa.eu/home/search/review/html/questions.en.html.

85 It is reminded that, under the division of competences between the ECB (within the Eurosystem) and Member States, the primary objective of monetary policy (which is, in literal terms, an economic policy as well, interacting with other economic policies, such as the fiscal policy, i.e., the main pillar of 'economic' policy as understood under the TFEU – a term equally not precisely defined therein) is the preservation of price stability. It is this division of competences in the asymmetric (by design) EMU which raises the problems underlying judicial disputes (as discussed above, under 3.1 in the example of the *Weiss case*). Nevertheless, without prejudice to this primary objective, the Eurosystem shall, *first*, support the general economic policies in the EU to contribute to the achievement of its objectives as laid

including interest rates and asset purchase programmes; and communication practices.[86] Accordingly, it is expected that the concerns raised in relation to limiting the financial excesses resulting from accommodative monetary policies will be adequately addressed therein.[87]

down in Article 3 TEU; and, *second*, act according to the principle of an open market economy with free competition, favouring an efficient allocation of resources (a 'generic' statement of respect for market economics) and in compliance with the principles set out in Article 119 TFEU (TFEU, Article 127(1), second sentence). On the interaction between monetary and fiscal policies in general, see, by means of mere indication, Elga Bartsch et al., 'It's all in the Mix. How Monetary and Fiscal Policies can Work or Fail Together' (2020) Geneva Reports on the World Economy 23; Victoria Meyer and Jack Caporal, *The Shifting Roles of Monetary and Fiscal Policy in Light of Covid-19*, Center For Strategic & International Studies (February 2021), csis.org/analysis/shifting-roles-monetary-and-fiscal-policy-light-covid-19.

[86] For an overall assessment, see Kronberger Kreis, 'Die geldpolitische Strategie der Europäischen Zentralbank: Was geändert werden sollte und was nicht' (2021) Kronberger Kreis-Studien No. 67. On the improvement, in particular, of the Eurosystem's communication practices, see Markus Demary and Michael Hüther, 'The ECB's strategy review: How monetary policy can be better communicated to the public' (*LSE European Politics and Policy (EUROPP) blog*, 09 December 2020).

[87] Pursuant to Don Kohn, (then) External Member of the Financial Policy Committee of the Bank of England: 'Monetary policy can have important effects on financial stability risks, but, for the most part, it is not the right policy to address those risks. I am concerned about burdening monetary policy with too much to do; putting weight on financial stability in monetary policy decisions implies less weight on economic and price stability in the conduct of policy, and that can have substantial costs in terms of economic welfare. Financial stability is a prerequisite for price and economic stability, so we cannot rule out adjusting monetary policy for financial stability purposes under some, hopefully rare, circumstances; but authorities should develop other tools and other decision processes to rely on first – macroprudential policies – and the more fully developed are these alternatives to monetary policy, the less monetary policy itself might need to be used to defend financial stability'. See Don Kohn, 'Monetary Policy and Financial Stability' (Speech, 21 May 2016) 3.

The role of the ECB was (and remains) important even beyond its capacity as a monetary authority within the Eurosystem. The prudential regulatory framework governing credit institutions provides certain elements of flexibility, making full use of which was deemed essential to overcome the financing pressures faced by firms and households. In this respect, the ECB, as a banking supervisory authority within the Single Supervisory Mechanism (SSM), and complemented by the European Banking Authority (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. Noteworthy is *also* its contribution in the field of financial macro-prudential oversight exercised, at EU (and not merely at euro area) level, by the European Systemic Risk Board (ESRB), which adopted several Recommendations to address pandemic-related systemic vulnerabilities. The ECB's role in the operation and decision-making process of the ESRB is significant.

Just before the outbreak of the pandemic crisis, EU credit institutions were (on average) well capitalised and with strong liquidity. Financial stability had also been overall enhanced compared to the decade before (as manifested, *inter alia*, by the quarterly Risk Dashboard of the EBA, which covered data of the 4th quarter of 2019[88]). Financial stability concerns during the current phase of the pandemic are acute, albeit not merely (or mainly) linked to the conduct of monetary policy, as (mainly) discussed in other contributions to this book.

[88] EBA, 'EU banks sail through the Corona crisis with sound capital ratios' (Press Release, 14 April 2020) eba.europa.eu/eu-banks-sail-through-corona-crisis-sound-capital-ratios.

Even though the overall resilience of the euro area banking sector still continues to be the basic scenario, taking into account the ECB's forecasts,[89] the path to recovery still remains uncertain (and is not expected to be smooth for all Member States[90]). By means of indication, according to the ECB's most recent Financial Stability Review,[91] risks to financial stability remain elevated and have become more unevenly distributed. Apparently, the main challenge, which should not be underestimated, remains the expected increase in the ratio of NPLs, across the board in relation both to credits and loans granted to corporates and households before the onset 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 granted during the current crisis (albeit in certain cases to ailing businesses covered by State guarantees).[92]

As noted in the foreword of the Review by the ECB Vice-President, Luis de Guindos: 'The pandemic has imposed higher costs on some vulnerable countries with larger services sectors, which in turn implies a greater need for continued policy support and growing interconnections between their

[89] ECB, 'Eurosystem Staff Macroeconomic Projections for the Euro Area' (*European Central Bank*, December 2020) ecb.europa.eu/pub/projections/html/ecb.projections202012_eurosystemstaff~bf8254a10a.en.html.

[90] See Kristalina Georgieva, 'Solidarity and Cooperation: Europe's Response to the Crisis' (Keynote Speech at the EU Parliamentary Conference, 22 February 2021).

[91] ECB, *Financial Stability Review* (May 2021), ecb.europa.eu/pub/pdf/fsr/ecb.fsr202105~757f727fe4.en.pdf.

[92] On this aspect, see also Christos V. Gortsos, *Non-performing Loans - New risks and policies? What factors drive the performance of national asset management companies?* (Directorate General for Internal Policies - Economic Governance Support Unit (EGOV, 2021), with extensive further references.

government, corporates and banks. More broadly, the euro area banking sector also continues to face headwinds, with its profitability subject to uncertainty about the balance of loan losses to come and provisions already booked.'[93]

[93] On the author's own views concerning threats to EU financial stability amidst the pandemic crisis and the various means to overcome them, see Christos V Gortsos, 'Threats to EU financial stability amidst the pandemic crisis' in Utrilla D and Shabbir A (eds): *EU Law in Times of Pandemic: The EU's Legal Response to COVID-19*, EU Law Live Press (2021), 311-321, with extensive further references. It is finally noted that, on 1 June 2021, the ESRB published a Report titled: *Lower for longer – macroprudential policy issues arising from the low interest rate environment*. It discusses the macroprudential policy issues arising from the low interest rate environment in the financial system of the EU in a forward-looking medium-term time horizon, esrb.europa.eu/news/pr/date/2021/html/esrb.pr210601~b459ba44ca.en.html. Due to time constraints, the analysis in that Report could not been taken into consideration in the present study.

Table 1: Evolution of the Eurosystem's consolidated balance sheet (2019-2021, in million EUR): the impact of the pandemic crisis

Assets				Liabilities			
	28.V. 2021	XII. 2020	XII. 2019		III. 2021	XII. 2020	XII.2019
1. Gold and gold receivables	499,159↓	536,542	470,742	1. Banknotes in circulation	1,469,431	1,434,512	1,292,742
2. Claims on non-euro area residents denominated in foreign currency	353,867	347,179↓	349,656	2. Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	4,264,373	3,489,194	1,813,377
				2.1 Current account (minimum reserve	3,503,749	2,805,331	1,537,667
				2.2 Deposit facility			
					758,898	683,863	275,710
3. Claims on euro area residents denominated in foreign currency	25,792	23,437	22,074	3. Other liabilities to euro area credit institutions denominated in euro	19,744↓	23,563	9,869
4. Claims on non-euro area residents denominated in euro	11,2111↓	14,337	17,491	4. Debt certificates issued	0	0	0
5. Lending to euro area credit institutions related to monetary policy operations denominated in euro	2,107,380	1,793,194	624,232	5. Liabilities to other euro area residents denominated in euro (general government & other liabilities)	717,774	611,304	311,769
5.1 MROs	376↓	468	7,904				
5.2 LTROs	2,107,004	1,792,574	616,188				
5.3 Marginal lending facility	0↓	152	140				
6. Other claims on euro area credit institutions denominated in euro	29,379	25,328	18,849	6. Liabilities to non-euro area residents denominated in euro	219,426↓	431,145	321,429
7. Securities of euro area residents denominated in euro	4,302,861	3,890,916	2,847,102	7. Liabilities to euro area residents denominated in foreign currency	10,551	7,816	7,734
8. General government debt denominated in euro	22,646↓	22,676	23,380	8. Liabilities to non-euro area residents denominated in foreign currency	2,128↓	3,895↓	7,408
9. Other assets	305,335↓	325,715	297,899	9. Counterpart of SDR allocated by the IMF	56,176	54,799↓	57,371
				10. Other liabilities	302,351↓	301,414	275,376
				11. Revaluation accounts	485,434↓	512,884	466,595
				12. Capital and reserves	110,242	108,797	107,555
TOTAL	**7,657,629**	**6,979,324**	**4,671,425**	**TOTAL**	**7,657,629**	**6,979,324**	**4,671,425**

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10. Next Generation EU: its meaning, challenges, and link to sustainability*

Carlos Bosque, David Ramos Muñoz, and Marco Lamandini

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1. Introduction

A previous related Article[1] started with Mario Draghi's statement,[2] comparing the financial consequences of the COVID-19 crisis with those of wars, and thus calling to

* The views expressed herein are those of the authors and not of the institutions with which they are affiliated.

[1] See Marco Lamandini, Guido Ottolenghi and David Ramos Munoz, 'What Recovery Fund for Europe? (For a dedicated equity line for business, and sound fiscal policy)' in Christos V Gortsos and Wolf-Georg Ringe (eds), *Pandemic Crisis and Financial Stability* (EBI 2020). Such article, in turn, was a follow up of Marco Lamandini, Guido Ottolenghi and David Ramos Munoz, 'Preparing for Safe and Sensible Economic Recovery! One daunting Thought and Three "Simple" Strategies to Bridge European and Italian Action?' (*EU Law Live*, 2 April 2020), eulawlive.com/ op-ed-preparing-for-safe-and-sensible-economic-recovery-one-daunting-thought-and-three-simple-strategies-to-bridge-european-and-italian-action-by-marco-lamandini.

[2] Mario Draghi, 'Draghi: we face a war against coronavirus and must mobilise accordingly' (*Financial Times*, 25 March 2020), ft.com/content/c6d2de3a-6ec5-11ea-89df-41bea055720b.

mobilise responses accordingly. Draghi weighed potential monetary and fiscal responses and subtly called to exercise solidarity between Member States (MSs). The monetary stimulus did not seem to be enough, and a different response was needed.

Things can move swiftly in a short time, for since the previous article was written, the EU has adopted a COVID-19 response, the COVID-19 response included Next Generation EU (NGEU), a fiscal stabilisation mechanism[3] inspired by solidarity[4] and transformational ambition, and Mr Draghi is no longer a central banker, but the prime minister of the largest recipient of NGEU funds, and widely seen as a welcome, safe pair of hands to ensure that EU's Hamiltonian moment lives up to its promise. The current ECB President, for her part, has praised NGEU's novelty[5] and possibly breathed a sigh of relief,

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[3] Although monetary policy is handled at EU level, fiscal policy remains in the hands of MSs. Hence, fiscal shocks are ultimately born by national economies. This fact is indeed expressly mentioned in the so-called state aid Temporary Framework (TF) put in place by the European Commission (Commission) in the prelude of the COVID-19 crisis: 'Given the limited size of the EU budget, the main response will come from Member States' national budgets. EU State aid rules enable Member States to take swift and effective action to support citizens and undertakings, in particular SMEs, facing economic difficulties due to the COVID-19 outbreak'. cf EC, 'Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak' (Communication, 19 March 2020) C/2020/1863 OJ C 91/1.

[4] The European Economic and Social Committee (EESC) characterised NGEU as 'An unprecedented exercise in solidarity'. See EESC, 'Next Generation EU recovery plan – An unprecedented exercise in solidarity' (Press release, 3 June 2020), eesc.europa.eu/en/news-media/press-releases/next-generation-eu-recovery-plan-unprecedented-exercise-solidarity.

[5] See Christine Lagarde, 'Europe's response to the crisis' (*The ECB blog*, 2020), ecb.europa.eu/press/blog/date/2020/html/ecb.blog200723~c06fafabb6.en.html.

seeing that the attention turns to the Commission and MS, leaving the ECB space to concentrate on its own strategic review. On top of that, on the other side of the Atlantic, the President of the United States has changed and promoted massive stimulus measures, raising questions about the suitability of NGEU to accomplish its goals.

Thus, NGEU's absolute novelty in the EU policy toolkit deserves a careful look at its basic features to understand where it fits within the broader scheme of COVID responses and what it is and what it is not (Section 2). Then, we will focus on the funding structure and sources of NGEU and the constitutional issues it raises (Section 3). In the third place, we will briefly discuss the tools (and challenges to bridge the gap between the aims of post-COVID 'recovery and resilience' and NGEU's transformational ambition), with a special focus on sustainability (Section 4). Finally, we will offer some tentative conclusions (Section 5).

2. What is Next Generation EU (and what it is not)[6]

2.1. Next Generation EU and the broader umbrella of COVID responses

The EU's broader response to the COVID-19 outbreak has been unprecedented, demanding a coordinated response not only between the EU and MS but also between EU Institutions and bodies. Such response has focused on four priorities:[7] (i)

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[6] The cut-off date of this article is 1st June 2021, so any potential development occurring after that date could not be taken into account.

[7] See response to Parliamentary question E-001156/2020 (22 June 2020), europarl.europa.eu/doceo/document/E-9-2020-001156-ASW_EN.html; and European Council, 'COVID-19 coronavirus pandemic: the EU's response', consilium.europa.eu/en/policies/coronavirus.

limiting the spread of the virus,[8] (ii) ensuring the provision of medical equipment,[9] (iii) promoting research for treatments and vaccines[10] and (iv) supporting jobs, businesses and the economy.[11]

NGEU is incardinated under the fourth priority, forming the fiscal response to enhance the economic resilience of jobs and markets. This axis comprises a wide variety of measures, among others: (i) the Pandemic Purchase Programme set up by the

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[8] EU initiatives comprised Recommendations and Guidelines on restraining non-essential mobility and on coordinated EU approach to COVID-19 travel measures launching Re-Open EU website to offer updated information on travel restrictions. More recently, in March 2021, the Commission presented two proposals: (i) Proposal for a Regulation of the European Parliament and of the Council on a framework for the issuance, verification and acceptance of interoperable certificates on vaccination, testing and recovery to facilitate free movement during the COVID-19 pandemic COM (2021) 130 final, and (ii) Proposal for a Regulation of the European Parliament and of the Council on a framework for the issuance, verification and acceptance of interoperable certificates on vaccination, testing and recovery to third-country nationals legally staying or legally residing in the territories of Member States during the COVID-19 pandemic COM (2021) 140 final (all together, the *Digital Green Certificate initiative*).

[9] Which included the creation of the rescEU, a stockpile of medical equipment (as part of the EU Civil Protection Mechanism) back in March 2020, the EU Solidarity for Health Initiative and waiving customs duties and VAT on the import of medical equipment from non-EU countries by means of Commission Decision (EU) 2020/491 of 3 April 2020 on relief from import duties and VAT exemption on importation granted for goods needed to combat the effects of the COVID-19 outbreak during 2020 (C/2020/2146) OJ L 103/1 (as subsequently extended by means of further Commission Decisions).

[10] Which includes the approval of COVID-19 vaccines by the European Medicines Agency (EMA), the execution of agreements with vaccine providers to secure them, and further financial support from the programme Horizon 2020 (amounting to 1 billion euros) to support coronavirus research.

[11] Economic measures will be referred immediately after. Also, it is to be noted that hand in hand with the measures associated to these four priorities, some horizontal initiatives can be spotted. Those include fight against disinformation and wider communication strategy.

ECB as a temporary asset purchase programme to mitigate the risks affecting the monetary policy transmission, (ii) the Temporary Framework for state aid resources put in place by the Commission to flexibilise the provision of state aid to mitigate COVID-19 related shocks in the market,[12] (iii) the temporary Support to mitigate Unemployment Risks in an Emergency (SURE),[13] (iv) the Coronavirus Response Investment Initiative (CRII and CRII+)[14] allowing Structural

[12] Articulated through a Commission communication and amended subsequently five times. Its validity is extended until 31 December 2021 (allowing the conversion of certain repayable instruments into grants until December 2022). For a consolidated version of the text and further information, see EC, 'The State Aid Temporary Framework', ec.europa.eu/competition-policy/state-aid/coronavirus/temporary-framework_en.

[13] Established Council Regulation (EU) 2020/672 of 19 May 2020 on the establishment of a European instrument for temporary support to mitigate unemployment risks in an emergency (SURE) following the COVID-19 outbreak [2020] OJ L 159.

[14] To this end, the Regulation (EU) No 1303/2013 of the European Parliament and of the Council of 17 December 2013 laying down common provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund, the European Agricultural Fund for Rural Development and the European Maritime and Fisheries Fund and laying down general provisions on the European Regional Development Fund, the European Social Fund, the Cohesion Fund and the European Maritime and Fisheries Fund and repealing Council Regulation (EC) No 1083/2006 [2013] OJ L 347 (Common Provisions Regulation) was subsequently modified by Regulation (EU) 2020/460 of the European Parliament and of the Council of 30 March 2020 amending Regulations (EU) No 1301/2013, (EU) No 1303/2013 and (EU) No 508/2014 as regards specific measures to mobilise investments in the healthcare systems of Member States and in other sectors of their economies in response to the COVID-19 outbreak (Coronavirus Response Investment Initiative) OJ L 99 and by Regulation (EU) 2020/558 of the European Parliament and of the Council of 23 April 2020 amending Regulations (EU) No 1301/2013 and (EU) No 1303/2013 as regards specific measures to provide exceptional flexibility for the use of the European Structural and Investments Funds in response to the COVID-19 outbreak OJ L 130. For a detailed analysis on the previous regulation and the use of European Structural

Funds to be repurposed to fight COVID-19 shocks and the mobilisation of additional support from them, and (iv) the European Guarantee Fund managed by the European Investment Bank (EIB), funded out of MSs' commitments[15] targeting companies[16] which are finally viable in the long-run but are experiencing shortages due to COVID-10 outbreak.

Under this fiscal response, reference must also be made to the InvestEU Programme,[17] established as the successor of the so-called *Juncker plan*.[18] Aiming at leveraging from the lessons learnt from EFSI implementation and established as a single

Funds Financial Instruments to respond to the COVID-19 financial crisis, see Fi-Compass, 'Responding to the COVID-19 crisis through financial instruments in the framework of the Coronavirus Response Investment Initiative' (European Commission and European Investment Bank, May 2020), fi-compass.eu/sites/default/files/publications/Responding%20to%20the%20COVID-19%20crisis%20through%20financial%20instruments_0.pdf.

[15] Having a targeted size of 25 billion euros, it expects to mobilise up to 200 billion euros of additional financing. The European Guarantee Fund is funded by participating countries in proportion to their share in the EIB or other institutions. See European Investment Bank, 'European Guarantee Fund', eib.org/en/products/egf/index.htm?q=&sortColumn=boardDate&sortDir=desc&pageNumber=0&itemPerPage=25&pageable=true&language=EN&defaultLanguage=EN&abstractProject=true&orabstractProject=true&orCountries=true&orBeneficiaries=true&orWebsite=true.

[16] The majority of them (65%) has been destined for SMEs.

[17] Established by Regulation (EU) 2021/523 of the European Parliament and of the Council of 24 March 2021 establishing the InvestEU Programme and amending Regulation (EU) 2015/1017 [2021] OJ L 107 (InvestEU Regulation).

[18] The Investment Plan for Europe under which the European Fund for Strategic Investments (EFSI) was set up. See Regulation (EU) 2015/1017 of the European Parliament and of the Council of 25 June 2015 on the European Fund for Strategic Investments, the European Investment Advisory Hub and the European Investment Project Portal and amending Regulations (EU) No 1291/2013 and (EU) No 1316/2013 [2015] OJ L 169.

fund (InvestEU Fund) [19] intends to 'provide more efficiently functioning support to final recipients by integrating and simplifying the financing offered under a single budgetary guarantee scheme'.[20].

2.2. Next Generation EU allocation and main purposes (what it is and what is not)

NGEU is not a *shock absorber* nor an instrument to provide liquidity to the economy.[21] On the contrary, NGEU tries to provide financial resources allowing MS to implement sustainable reforms with a view to tackling the undesired consequences of the COVID-19 outbreak.[22] This makes it a remarkable instrument with unique features, which is worth discussing, even briefly.

Even if it is not our purpose to minutely discuss all the RRF legal features, but to examine its links with sustainable finance, to achieve that purpose, we must look at the basic features encompassing the set-up and implementation of the RRF.[23]

[19] InvestEU Regulation, ch II, Arts 8-10.
[20] InvestEU Regulation, recital 2.
[21] For those purposes, other instruments were devised. Among those, the already cited CRII and CRII+ initiative as well as the EGF.
[22] Regulation (EU) 2021/241 of the European Parliament and of the Council of 12 February 2021 establishing the Recovery and Resilience Facility [2021] OJ L 57 (RRF Regulation), recital 8. It is acknowledged that crises, such as the COVID-19, may entail cutting (public) investments, in particular in sectors perceived as less relevant or profitable (e.g. cultural and research sectors). RRF aims at tackling such adverse effects, providing resources that allow MSs to build up resilience.
[23] For a thorough analysis of the Facility, including its preparatory works, see Jonathan Echebarria Fernández, 'A Critical Analysis on the European Union's Measures to Overcome the Economic Impact of the COVID-19 Pandemic' (2021) 5 European Papers 1399.

First, one needs to look at the RRF *time horizon*. RRF is conceived as a temporary recovery instrument,[24] and its duration is established accordingly, in line with the provisions of Regulation 2020/2094. In this vein, the investments and reforms supported by it should be completed by 31 August 2026.[25]

Second, the RRF refers to relevant EU policy areas, which are structured in six pillars for the purposes of the RRF Regulation. Those are (a) green transition; (b) digital transformation; (c) smart, sustainable and inclusive growth; (d) social and territorial cohesion; (e) health, and economic, social and institutional resilience; and (f) policies for the next generation, children and the youth.[26] Those pillars define the scope of the facility and serve to attain a general objective: to build up EU resilience in the aftermath of the pandemic[27] and a specific objective, which is to provide the necessary financing to MSs to attain the objectives foreseen in the national recoveries plan.[28]

Third, the keystone that sits in the middle of the RRF implementation process and sustains the whole architecture is

[24] Council Regulation (EU) 2020/2094 of 14 December 2020 establishing a European Union Recovery Instrument to support the recovery in the aftermath of the COVID-19 crisis [2020] OJ LI 433, recital 6. The Regulation established the upper limits of the resources aimed to support the recovery in the aftermath of the COVID-19 crisis in Article 1(1) and Article 2(2). Concerning the allocation of funds, the amounts foreseen in Article 2(2)(a)(ii) (312,500 million euros in the form of non-repayable assistance) and 2(2)(b) (360,000 million euros in loans to MSs) are allocated to the RRF. See RRF Regulation, Article 6(1).
[25] Where, in principle, by 31 August 2026, the investments and reforms should be completed. See RRF Regulation, Articles 18(4)(i), 20(4)(d) and recital 53.
[26] RRF Regulation, Article 3.
[27] RRF Regulation, Article 4(1).
[28] RRF Regulation, Article 4(2).

national recovery and resilience plans (NRRP). Those are prepared by MSs in accordance with their national laws and must explain, in detail, how the state aims at attaining the different pillars and broader RRF objectives,[29] detailing the specific measures and reforms to be carried out within the relevant plan. The Commission is expected to assess those NRRP[30] weighing their relevance, effectiveness, efficiency, and coherence.[31] Should the Commission´s positively assess the NRRP, it will submit a proposal to the Council, which must approve the Commission assessment by means of an implementing decision.[32]

Four, the RRF Regulation does not establish a limitative type of measures that can be supported through NRRP. Those are simply presented as measures intended to attain the pillars indicated in Article 3 of RRF Regulation, and the specific challenges for MSs, contributing to enhance resilience and tackle the impact of the COVID-19 crisis.[33] The facility could also be deployed via investment schemes, which should act as

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[29] RRF Regulation, Article 18 provides prolific details of the different elements that must be covered in the NRRP.

[30] Which are expected to be submitted by 30 April 2021 (Article 18(3) RRF Regulation), although the RRF Regulation also contemplated the submission of *draft* NRRP. The purpose of allowing the submission of those draft NRRPs is to speed up the approval of an implementation process (Recital 38 of RRF Regulation). However, it is not clear whether the Commission may provide informal feedback on those or they may be simply considered, after the entry of the RRF Regulation into force, as *final* NRRP (or they became such upon MS's confirmation).

[31] Those assessment criteria are further detailed in Article 19(3) RRF Regulation.

[32] RRF Regulation, Article 20. It seems that the Council is not given discretion (not even grounds) to reject the Commission's assessment and must approve the assessment as a kind of *rubber stamp* exercise.

[33] RRF Regulation, Article 18(4)(a) and recital 8.

a catalyst of private investments, such as financial instruments, subsidies and non-repayable assistance.[34]

The Commission Guidance on Recovery and Resilience Plans (NRRP Guidance)[35] provides further guidance regarding the type of investments that can be financed by the NRRPs. Under this NRRP Guidance (and, thus, the RRF Regulation) 'investments' is broadly conceived 'as capital formation in areas such as fixed capital, human capital, and natural capital'.[36] Those include direct and indirect schemes, financial instruments,[37] subsidies, support schemes, and similar facilities. The facility can also finance reforms with a view to complement the effect of investments.[38]

Five, and final, sustainability language is embedded in the instrument. On the one hand, the RRF is expected to contribute to attaining an overall 30% EU budget expenditure supporting climate objectives.[39] In this regard, the measures included and supported in the NRRP should contribute to a green transition in a share that represents at least 37% of the total allocation.[40]

[34] Ensuring in such cases that State aid rules are complied with (Recital 8 of RRF Regulation).
[35] EC, 'Guidance to Member States Recovery and Resilience Plans' (Commission Staff Working Document, 22 January 2021) SWD (2021) 12 final Part 1/2, ec.europa.eu/info/sites/default/files/document_travail_service_part1_v2_en.pdf, and Part 2/2 ec.europa.eu/info/sites/default/files/document_travail_service_part2_v3_en.pdf.
[36] NRRP Guidance pt 2/2 5-9.
[37] Including also venture capital investments and equity financial instruments.
[38] It must be noted that reforms may not entail funding, but are, nevertheless, included in the NRRP as long as they are linked to other reforms and investments.
[39] RRF Regulation, recital 23.
[40] Following the tracking methodology defined in Annex VI of RRF Regulation. See RRF Regulation, Recital 23 and Article 18(4)(e).

On the other hand, and as a horizontal principle,[41] the RRF should also support measures that respect the principle of *do no significant harm* as defined in the Taxonomy Regulation.[42]

2.3. Complementarities and differences with InvestEU

InvestEU, as indicated above, can also be incardinated under the overall EU response to tackle the effects produced by the COVID-19 pandemic and provide funding to support EU response in the long run.[43]

The InvestEU Fund,[44] the centrepiece of the InvestEU Programme, serves a different purpose and is set up under a different logic, which is to support the objectives of EU internal policies,[45] although some of the objectives pursued by the RRF and the InvestEU Fund are similar, when not purely complementary.[46] Both instruments also differ in the manner

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41 RRF Regulation, Article 5(2).

42 Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 [2020] OJ L 198. See RRF Regulation, Article 2(6).

43 See EC, 'Questions and Answers: The proposed InvestEU Programme' (*European Commission*, 29 May 2020), ec.europa.eu/commission/presscorner/detail/pt/qanda_20_947.

44 InvestEU Regulation, ch II, arts 8-10.

45 InvestEU Regulation, Article 1(1).

46 For instance, the InvestEU programme aims at contributing to sustainable and inclusive recovery, in the aftermath of the COVID-19 crisis (Article 1(1)(g) InvestEU Regulation). This aim constitutes also the general objective of the RRF (Article 4(1) RRF). Digital transformation (Article 8(1)(a) InvestEU Regulation and Article 3(b) RRF Regulation), inclusion (Article 3(1)(c) InvestEU Regulation and Article 3(c) RRF Regulation) and territorial and social cohesion (Article 3(1)(f) InvestEU Regulation and Article 3(d) RRF Regulation), among others, constitute common areas of regulatory scope for both instruments.

they are implemented, the form of funding and the manner they interact with each other:

First, whereas RRF is implemented under direct management by the Commission,[47] InvestEU Fund is implemented under indirect management.[48] This means that the InvestEU Fund is implemented by the implementing partners selected by the Commission,[49] and the RRF is, in principle, directly managed by the Commission. The distinction may be more formalistic than real since the RRF is ultimately implemented via NRRPs drafted out by MSs. Yet, those NRRPs must first be positively assessed by the Commission, and the payment of instalments is ultimately subject to the achievement of the milestones contemplated therein, on which MSs must periodically report to the Commission.[50]

InvestEU differs from RRF also in its structure. InvestEU contemplates the set-up of two main fund compartments: an EU

[47] Pursuant to Article 62(1)(a) Regulation (EU, Euratom) 2018/1046 of the European Parliament and of the Council of 18 July 2018 on the financial rules applicable to the general budget of the Union, amending Regulations (EU) No 1296/2013, (EU) No 1301/2013, (EU) No 1303/2013, (EU) No 1304/2013, (EU) No 1309/2013, (EU) No 1316/2013, (EU) No 223/2014, (EU) No 283/2014, and Decision No 541/2014/EU and repealing Regulation (EU, Euratom) No 966/2012 [2018] OJ L 193 (Financial Regulation). See Article 8 RRF Regulation and Article 6(1) InvestEU Regulation.

[48] Article 62(1)(c) Financial Regulation.

[49] With the exception of the European Investment Bank Group that, pursuant to Article 13(4) InvestEU Regulation, constitutes a privileged partner for the implementation of the 75% of the EU Compartment of the InvestEU Fund (see recital 50 InvestEU Regulation). Implementing partners encompass financial institutions (including national promotional banks) and other financial intermediaries selected by the Commission for the purposes of implementing the InvestEU Fund, entering into a guarantee agreement for that end (Article 2(13) InvestEU Regulation).

[50] RRF Regulation, Arts 20(5)(a) and 23(2).

compartment[51] and a MS compartment to be set up voluntarily (up to one per MS).[52] The RRF, for its part, is implemented via NRRP, in principle, one per each MS, tackling their specific resilience issues.

Second, another difference is in the form of support backing each instrument. The EU compartment of the InvestEU Fund is backed by an EU irrevocable guarantee in an amount of 26.2 billion euros,[53] expecting to mobilise more than 372 billion euros.[54] The RRF, on its side, is allocated with 312 billion euros dedicated for non-repayable financial support,[55] plus 360 billion euros in the form of loans available to MSs,[56] if they so request.[57]

Third, from the perspective of the complementarities and interconnection, it is foreseen that MS can contribute RRF resources to the MS Compartment of the InvestEU Fund.[58] However, contributing resources from the InvestEU Fund to the NRRP is not contemplated in the applicable framework and hence, does not seem possible.

[51] InvestEU Regulation, Article 9. In principle addressing EU wide market failures or suboptimal investment situations (see Recital 32 InvestEU Regulation).
[52] InvestEU Regulation, Article 10. Addressing specific MS's market failures or suboptimal investments situations.
[53] InvestEU Regulation, Article 4(1) and 40 Recital.
[54] See Council of the EU, 'InvestEU programme adopted by Council' (Press Release, 17 March 2021), consilium.europa.eu/en/press/press-releases/2021/03/17/investeu-programme-adopted-by-council.
[55] RRF Regulation, Article 5(1)(a).
[56] RRF Regulation, Article 5(1)(b).
[57] See below, section 3.
[58] In the form of cash contributions (Article 7(2) RRF Regulation and Article 10(1) InvestEU Regulation).

The design and targets of NGEU show some similarities and some differences, with different academic proposals that were floated and discussed before it was even a project, including by some of us.[59]

In terms of similarities, the RRF shows pragmatism and ambition. One can dispute whether the ambition is commensurate with the challenge, but it is an example of problem-solving-based thinking, which is refreshing. This is also shown in a structure, which, with its own intricacies, could certainly have been much more complicated. Another similarity is the focus not on covering past costs but on investing in the future, and an explicit emphasis on innovation and sustainability, which is most welcome.

Among the differences is a lack of emphasis on equity funding. RRF funds will be allocated to MSs and then distributed in accordance with their NRRPs, and there is no stated preference in the NRRP Guidance about the kind of instruments to be used. There is an emphasis on the 'crowding in' of private investments,[60] or the need to finance 'capital', understood as assets, or human capital,[61] but this investment can be funded via

[59] Lamandini, Ottolenghi and Ramos Muñoz (n 1a) 245; (n 1b). Consonant views were voiced, in parallel, from influential economists. Cf Arnoud WA Boot et al., 'Corona and Financial Stability 3.0: Try equity-risk sharing for companies, large and small' (2020) SAFE Policy Letter No. 81; Arnoud WA Boot et al., 'Corona and Financial Stability 4.0: Implementing a European Pandemic Equity Fund' (2020) SAFE Policy Letter No. 84; Giorgio Gobbi, Francesco Palazzi and Anatoli Segura, 'Unintended effects of loan guarantees during the Covid-19 crisis' in Agnès Bénassy-Quéré and Beatrice Weder di Mauro (eds), *Europe in the Time of Covid-19* (VoxEU.org & CEPR Press 2020).

[60] See NRRP Guidance pt 1/2 17, 43.

[61] 'The Regulation is therefore consistent with a broad concept of investment as capital formation in areas such as fixed capital, human capital, and natural capital. This would also cover for instance intangible assets such as R&D,

equity lines, venture capital, loans,[62] etc. For example, the EU policy approach focuses on the 'asset side', but it is neutral (or blind) towards the liability side. In our view, although understandably deferential towards MSs, this approach is questionable: given that levels of private (and corporate) debt in the EU are high and growing,[63] and capital markets remain below potential, and are a marginal source of funding for SMEs.[64] Thus, absent other considerations, a suitable way to 'crowd in' private investment and promote capital markets integration in the process would be to shift the focus away from debt (especially bank debt) financing, and towards equity financing, with a decisive boost to venture capital. This has not been done, and even though we are in no way naysayers and praise NGEU for its significance, it still has blind spots, and this may be the biggest one. A similar blind spot is present in the InvestEU context, despite the fact that one of its six pillars is devoted to solvency support, also through investment in equity or quasi-equity, for undertakings that were sound and safe at the unfolding of the Corona crisis. It remains thus to be seen how this line of intervention shall be engineered in practice

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data, intellectual property and skills. Investments should also respect the "do no significant harm" principle'. See NRRP Guidance pt 1/2 16.

[62] 'This would include inter alia, guarantees, loans, equity and venture capital instruments and the setting-up of dedicated investment vehicles. See NRRP Guidance pt 1/2 17.

[63] See Eurostat, 'Private sector debt, consolidated - % of GDP', ec.europa.eu/eurostat/databrowser/view/tipspd20/default/table?lang=en.

[64] 'The proportion of new equity risk capital as a share of total funding for EU SMEs declined from 2.5% in 2019 to 1.8% in H1 2020 (and from 2.0% in 2015) […] Bank lending to EU27 SMEs totalled EUR 573bn in H1 2020 compared with only EUR 14.1bn in risk capital investment (venture capital, private equity, business angel and equity crowdfunding).' See Association for Financial Markets in Europe, 'Capital Markets Union Key Performance Indicators – Third Edition European 2020'.

3. Financing Next Generation EU & RRF, and constitutional and political issues

Amounts related to the financial contribution[65] allocated to RRF are made available to MSs depending on the positive assessment their NRRPs[66] receive from the Commission.[67] Where the NRRP is assessed positively and the estimated costs associated are higher than the maximum financial contribution it can receive, the financial contribution will be equal to that maximum financial contribution.[68] In the same case (positive assessment), where the estimated costs of the NRRP are lower than the maximum financial contribution it can receive, then the financial contribution allocated will amount to the estimated costs of the NRRP.[69] Where MSs consider that they may need additional financial support,[70] they may request and justify additional funds in the form of a loan[71] to be applied to carry out the measures contemplated in the respective NRRP.

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[65] Meaning non-repayable financial support (Article 2(2) RRF Regulation). The total amount of the financial contribution allocated to the RRF is 312 billion euros.

[66] Should the assessment be negative, the Commission will not grant any financial contribution to the MS at stake (Article 20(4)(c) RRF Regulation).

[67] The maximum financial contribution a MS can receive is calculated, pursuant to Article 11 and Annexes II and III RRF Regulation, based on: '(a) (…) the population, the inverse of the GDP per capita and the relative unemployment rate of each Member State (weighting 70%) and (b) (…) the population, the inverse of the GDP per capita and, in equal proportion, the change in real GDP in 2020 and the aggregated change in real GDP for the period 2020-2021' (weighting the remaining 30%).

[68] ibid.

[69] RRF Regulation, Article 20(4). In the latter case, this would not impede the relevant MS to revise its NRRP with a view to get it amended, potentially increasing the amount of the financial contribution.

[70] RRF Regulation, Arts. 14, 15, 18(4)(s) and 20.

[71] RRF allocates up to 360 billion euros available for loans to be granted to MSs upon request and justification.

How is this extraordinary fiscal support financed? The Own Resources Decision[72] provides the answer. Article 5 of this Decision authorises the Commission, as an extraordinary mechanism, (i) to borrow from capital markets up to 750 billion euros, and (ii) to grant loans in up to 360 billion euros to fund the RRF (and also the sectoral initiatives tackling the consequences of the COVID-19 pandemic). As per the chunk not comprising loans (750 billion euros), the Commission is entrusted with the task of managing the issuances in capital markets, ensuring that and remaining periodically accountable to the European Parliament and the Council.[73]

The Own Resources Decision entry into force is subject to its adoption by all MSs, in accordance with their respective constitutional requirements.[74] In the process of adoption by national parliaments and institutions, the package of reforms has also been subject to court challenges, which have resulted in different responses, which, in turn, reflect different approaches to the relationship between EU Law and national constitutional law. Although such a topic well deserves a dedicated study, for present purposes, we will limit ourselves to simply offer some context of the developments so far related to it.

On 26 March 2021, the German Constitutional Court (GCC) prevented the German President, Frank-Walter Steinmeier, from signing – and enacting – the relevant German legislation

[72] Council Decision (EU, Euratom) 2020/2053 of 14 December 2020 on the system of own resources of the European Union and repealing Decision 2014/335/EU, Euratom [2020] OJ L 424.
[73] Own Resources Decision, Article 5(3).
[74] Own Resources Decision, Article 12.

approving the Own Resources Decision.[75] The reason? A claim filed by a group of German citizens together with one of the spokespersons of the right-wing Eurosceptic party Alternative for Germany (AfD). They pleaded that the Own Resources Decision constitutes a flagrant violation of the Treaties, as it increases the ceiling of own resources to allow funding RRF and sectoral approaches put in place to tackle the effects of COVID-19,[76] and that this is at odds with the principle of maintaining a balanced budget.

The episode was preluded as being a second part of the clash on 5 May 2020, when the GCC found that the Public Sector Purchase Programme (PSPP) exceeded the ECB's mandate.[77] Yet, the complaint did not precipitate a(nother) crisis, as the GCC dismissed the applicants' request for a preliminary injunction that would have prevented Germany from ratifying the legislative instrument to approve the Own Resources Decision.[78] However, the GCC did not find the constitutional

[75] Journals soon echoed this news. See, among other, Michael Nienaber, 'German constitutional court stops ratification of EU recovery fund' (*Reuters*, 26 March 2021), reuters.com/article/us-health-coronavirus-eu-debt/german-constitutional-court-stops-ratification-of-eu-recovery-fund-idUKKBN2B I2FR . In addition, it seems that the GCC, at the very first moment, did not issue an injunction, but published and communicated a statement.

[76] See Cruz Vilaça Advogados, 'The German Constitutional Court calls into question the Recovery and Resilience Plan' (1 April 2021), cruzvilaca.eu/en/news/The-German-Constitutional-Court-calls-into-question -the-Recovery-and-Resilience-Plan/138.

[77] See FCC judgement of 5 May 2020 (2 BvR 859/15). For an English version of the judgement, see bundesverfassungsgericht.de/SharedDocs/ Entscheidungen/EN/2020/05/rs20200505_2bvr085915en.html.

[78] See Bundesverfassungsgericht, 'Unsuccessful application for preliminary injunction against promulgation of the domestic act ratifying the EU Own Resources Decision ("EU Recovery Package")' (Press Release No. 29/2021, 21 April 2021), bundesverfassungsgericht.de/SharedDocs/Pressemitteilungen/EN/2021/bvg21-029.html.

complaint to be fully unfounded or inadmissible from the outset and, thus, still needs to adjudicate on the substance of the case.

Yet, once again, the GCC continues pursuing the path of examining the legality of EU acts from the prism of its constitutional framework. The EU may hold its breath during the upcoming months. The GCC includes some indications of its way of thinking, by stating that: (i) in principle, 'the Council Decision does not envisage any additional borrowing on behalf of the European Union,' (ii) the Federal Government enjoys wide discretion in this area, to which the GCC must abide, and (iii) anticipating that it would be keen to ask the Court of Justice to rule on the validity of the Own Resources Decision.[79] Nevertheless, previous experience shows that the GCC is unpredictable. We can only hope that should doubt arise on the compatibility of the Own Resources Decision with the German Constitution, the GCC would engage in a more constructive dialogue with the Court of Justice and with the EU Institutions.[80]

As of 1 June 2021, all MSs have ratified the Own Resources Decision.[81] As the German case illustrates, this ratification

[79] ibid. For some preliminary analysis, see Benedikt Riedl, 'La décision sur les ressources propres et le fonds de développement "Next Generation EU", un acte ultra vires et/ou une violation de l'identité constitutionnelle?' (2021) Blogdroiteuropeen Working Paper 3/2021.

[80] See Marco Lamandini, David Ramos Muñoz and Violeta Ruiz Almendral, 'The EMU and its Multi-Level Constitutional Structure: The Need for More Imaginative "Dialogue" Among and Across EU and National Institutions' (2020) 47 Legal Issues of Economic Integration 311.

[81] See Council of the EU, 'Green light from all member states for EU recovery spending' (Press Release, 31 May 2021), consilium.europa.eu/en/press/press-releases/2021/05/31/green-light-from-all-member-states-for-eu-recovery-spending.

process has not been easy. For instance, on 20 May 2021, five MSs were still pending to ratify the Own Resources Decision.[82]

With the largest EU economies on board, the process of ratification gained momentum, although some constitutional tensions remained until the very end (mainly regarding Poland and Hungary). The last episode of the tortuous entry into force of the Own Resources Decision took place in Romania, where a Parliamentary blockage put the Own Resources Decision approval on hold.[83].

4. Next Generation EU, RRF, and sustainability

Funding RRF (and overall NGEU) requires raising an unprecedented amount of funds from capital markets. The Commission raising funds from capital markets is nothing new. For instance, it borrowed in 2020 to fund SURE.[84] However, considering the high total and yearly volumes to be raised – Euros 150 billion approx. –, the Commission has put in place a new approach trying to minimise execution risks and with a view to ensuring cost-efficiency.

The basis for such a new funding strategy is the *Communication on a new funding strategy to finance NextGenerationEU*

[82] Alessandro D'Alfonso, 'National ratification of the Own Resources Decision' (European Parliament Briefing, June 2021), europarl.europa.eu/RegData/etudes/BRIE/2021/690520/EPRS_BRI(2021)690520_EN.pdf. Those MSs are the Netherlands, Poland, Austria, Hungary and Romania.

[83] See Bogdan Neagu, 'Romania's PSD blocks approval of EU's own resources decision' (*Euractiv*, 11 March 2021), euractiv.com/section/politics/short_news/romanias-psd-blocks-approval-of-eus-own-resources-decision.

[84] In an amount of circa 75 billion euros (out of 100 billion euros, which constitute the ceiling of SURE).

(Commission Communication)[85] and builds upon diversification.[86] The basic features of this strategy can be summarised as follows:

(i) Defining periodically the volumes to be raised. To this end, the Commission will adopt an annual framework borrowing decision.[87] Further, via *funding plans*, the indicative targets for the funds to be raised shall be established.[88] This would enhance predictability and transparency, allowing interested investors to be timely prepared to make their investment decisions.[89]

(ii) The fundraising will be executed via a pan-European Primary Dealer Network. European supervised credit institutions and certain investment firms meeting the eligibility criteria[90] and requesting to participate in the

[85] EC, 'A new funding strategy to finance NextGenerationEU' (Communication from the Commission to the European Parliament and the Council, 14 April 2021) COM (2021) 250 final.

[86] In line with common practices undertaken by sovereign issuers. See Udaibir S Das, Michael G Papaioannou and Magdalena Polan, 'Strategic considerations for first-time sovereign bond issuers' (2008) IMF Working Paper WP/08/261.

[87] EC (n 85) s 2.1. See, also, Article 3 Commission Implementing Decision establishing the necessary arrangements for the administration of the borrowing operations under Council Decision (EU, Euratom) 2020/2053 and for the lending operations related to loans granted in accordance with Article 15 of Regulation (EU) 2021/241 of the European Parliament and of the Council C (2021) 2502 final (Implementing Decision).

[88] On a six-months basis.

[89] EC (n 85) s 2.1 and Implementing Decision, Article 5.

[90] EC (n 85) s 2.4 and Commission Decision of 14.4.2021 on specific internal rules on the implementation of borrowing, debt management and lending operations and of the primary dealer network established by Commission Decision C (2021) 2500. The relevant eligibility criteria are established in the Commission Decision (EU, Euratom) 2021/625 of 14 April 2021 on the establishment of the primary dealer network and the definition of eligibility criteria for lead and co-lead mandates for syndicated transactions for the

network,[91] upon Commission's acceptance, will be part of the network, enjoying the rights and bearing the obligations such membership entail. The selected institutions will act as placers, allocating debt securities in the primary market and promoting the liquidity of the mechanism.

(iii) Bond issuance will cover, as it may be needed, a wide range of maturities, from three to thirty years. The foregoing ensures flexibility so as to avoid liquidity shortfalls.

The foregoing will be coupled with cost-efficient pricing strategies, relying on auctions, syndications transactions, or private placements as well as including taps bonds,92 as it may be appropriate considering the size and nature of the operations.93

The Commission has managed to fit a sustainability dimension within this complex framework, as it envisages funding 30% of NGEU by means of *green bond issuance*.[94] To achieve that, the

purposes of the borrowing activities by the Commission on behalf of the Union and of the European Atomic Energy Community C (2021) 2500 OJ L 131/170. The foregoing Commission Decision has been further amended by Commission Decision (EU) 2021/857 of 27 May 2021 amending Decision (EU, Euratom) 2021/625 as regards the inclusion of certain investment firms in the eligibility criteria for membership of the Union primary dealer network C (2021) 3739 OJ L 188/103.

[91] For the Call for Applications and related documents see EC, 'EU funding strategy for NextGenerationEU' (Legal Texts), ec.europa.eu/info/strategy/eu-budget/eu-borrower-investor-relations/legal-texts_en#eu-funding-strategy-for-nextgenerationeu.

[92] They entail a portion of an issued bond that is held back and later issued based on the existing bond. See EC (n 85) s 2.

[93] EC (n 85) s 2.4 and Implementing Decision, recital 4.

[94] In line with the objective of reorienting capital flows to sustainable finance included in the Action Plan.

Commission contemplates adopting an NGEU Green Bond Framework,[95] aligning to the furthest extent possible with the EU Green Bond Standard.[96] Those bonds should finance climate-related investments contemplated in the NRRP. That climate-related expenditure, eligible for the purposes of NGEU *green bond issuance*, should be identified based on the methodology for climate tracking foreseen in Annex VI of the RRF Regulation.[97]

This aim of the NGEU fits within the broader interest at an EU level in ensuring that EU funds are used for attaining sustainability principles or implemented in accordance with ESG principles.[98] This interest has become more evident after

[95] Expected to be published by early summer.

[96] 'Our NGEU Funding Strategy will include a Green Bond issuance programme of up to €250 billion to meet the 30% target. The European Commission is working on a green bond framework and we are confident that Member States will live up to their responsibility as well. Once adopted, a Green Bond programme of this scale will make the EU the biggest issuer of sustainable bonds on the financial markets'. See EC, 'Presentation by Commissioner Hahn of the NextGenerationEU – Funding strategy to finance the Recovery Plan for Europe' (Speech, 14 April 2021), ec.europa.eu/commission/presscorner/detail/en/SPEECH_21_1743.

[97] Yet, one may expect the Commission to provide further guidance on this matter. For instance, technical guidance is expected to be provided on how the 'Do No Significant Harm' principle applies in the context of the RRF (see NRRP Guidance s 8).

[98] It is broadly understood (in the academia, among policy makers as well as in the private sector) that *sustainable finance* encompasses (a) the provision of financial services (or more generally, performing investments); (b) integrating Environment, Social and Governance (ESG) criteria in the final business decisions; (c) aiming to make a long-term/durable for investors, investees, the society and broadly, all the concerned stakeholders. See, for a short overview, Carlos Bosque, 'Putting sustainable finance at the very centre of EU development (and beyond)' (2020) EBI BrieFin #3 Sustainable Finance.

the ratification of the Paris Agreement,[99] the decarbonisation objectives for 2050,[100] and the 'European Green Deal'.[101] These initiatives at a broader policy level have taken shape in the context of financial markets through the EU Commission Action Plan on Sustainable Finance (Action Plan),[102] which envisages fostering investment in sustainable projects, using EU funds to catalyse and attract private investments,[103] or *reorienting capital flows towards a more sustainable economy*. Post-2020, the EU is committed to transition to a more sustainable economy and has pledged to make at least 25% of its budget directly climate-relevant.[104]

[99] United Nations Framework Convention on Climate Change (The Paris Agreement) [2015].
[100] EC, 'A Clean Planet for all: A European strategic long-term vision for a prosperous, modern, competitive and climate neutral economy' (Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Investment Bank, 28 November 2018) COM (2018) 773 final, eur-lex.europa.eu/legal-content/en/ALL/?uri=CELEX%3A52018DC 0773.
[101] EC, 'The European Green Deal' (Communication from the Commission to the European Parliament, the European Council, the Council, the European Economic and Social Committee, the Committee of the Regions, 11 December 2019) COM (2019) 640 final, eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM% 3A2019%3A640%3AFIN.
[102] EC, 'Action Plan: Financing Sustainable Growth' (Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, 8 March 2018) COM (2018) 97 final, eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52018DC 0097.
[103] ibid. s 2.3. See, also, Commission short explanation of the Action Plan in EC, 'Commission action plan on financing sustainable growth' (Publication, 8 March 2018), ec.europa.eu/info/publications/sustainable-finance-renewed-strategy _en.
[104] EC (n 101) s 2.2.1 (further updated to 30%). See also RRF Regulation, recital 23.

Having made such pledges, it was relatively natural for the NGEU to openly embrace sustainability. It is important to note that sustainability's importance goes beyond the specific obligations and reaches the level of the principles underpinning the relevant regulations. The RRF Regulation is embedded in sustainability principles. It stems from the preamble that the objective of the Facility is to contribute to building up resilience *through sustainability*, thus not acting as pure shock or fiscal absorber. Its aim is (i) to contribute to attaining global EU climate commitments[105] by turning those commitments into General objectives,[106] together with goals such as sustainable recovery, and (ii) to support sustainable growth.[107] More specifically, NRRPs are expected to contribute in a share of at least 37% to climate targets.[108]

Although there are many references to sustainability principles, there are less to specific tools (a) to ensure that measures implemented are actually respectful with those principles or (b) to track such compliance. Nevertheless, it is worth also noticing that RRF Regulation is only the regulation *enabling* the implementation of the RRF: it is for MSs through their NRRPs to ensure that measures implemented out of RRF support comply with those principles and objectives.

This opens an important gap between the EU policy level and the MSs' implementation level. However, in this sense, the reference to the funding via green bonds has been a smart way to enlist the aid of capital markets in putting pressure on the Member States to comply with internationally accepted

[105] RRF Regulation, recitals 4, 7 and 11.
[106] RRF Regulation, Article 4(1).
[107] RRF Regulation, recital 11.
[108] RRF Regulation, Article 16(2)(b).

standards as to the use of funds. Furthermore, there are mechanisms in the relevant regulations to facilitate such compliance.

For starters, measures included in the NRRP must comply with the principle of *do no significant harm*, contemplated in the Taxonomy Regulation,[109] with several references in the RRF Regulation,[110] a point that is also stressed in the European Commission Guidance to national plans,[111] which can be assessed *ex ante* through the approval process undertaken by the Commission itself.

In addition, MSs must also define in the NRRPs the modalities of reporting and monitoring. Furthermore, additional reporting can be envisaged in the context of the European Semester,[112] and an annual overall reporting is to be prepared by the Commission,[113] plus climate tracking can also be used[114] to *prove* to the Commission that the overall target is attained.

Some of us have tried to provide a framework to analyse the legal measures adopted to attain sustainability across financial markets (to 'mainstream' it, beyond a niche investment), distinguishing between 'Exit', 'Voice', and 'Coercion' mechanisms.[115] Drawing an analogy with the private sector, most mechanisms within NGEU (and the RRF) are

[109] Regulation 2020/852, Article 17.
[110] RRF Regulation, recital 25 and Arts 18(4)(d) and 19(4)(d).
[111] NRRP Guidance, s 8.
[112] RRF Regulation, Article 27.
[113] RRF Regulation, Article 31(3)(a).
[114] RRF Regulation, Annex VI.
[115] David Ramos Muñoz, Elia Cerrato and Marco Lamandini, 'The EU's "green" finance. Can "exit", "voice" and "coercion" be enlisted to aid sustainability goals?' (2021) European Banking Institute Working Paper Series - no. 90.

‘transparency-based’ (and, thus, ‘exit-based’). There are disclosure and reporting requirements on an *ex ante* and *ex post* basis. These are accompanied by potential ‘voice-based’ mechanisms, which force potentially reluctant actors to explain how exactly they plan to meet sustainability objectives.

The hardest, as usual, is to accompany these by ‘coercion-based’ mechanisms. In principle, if the reforms and investments funded by the RRF are improperly implemented, the Commission could retain or suspend payments.[116] Whether it would be plausible for this possibility to be used in a case where a MS does not contribute to attaining the sustainability principles enshrined in the RRF Regulation and/or does not respect the principle of *do no significant harm* is another matter. In practice, this would be rendered quite difficult by the fact that some ulterior guidance would be needed to understand what it would mean to ‘not comply’ or ‘not attain’ those objectives, guidance that should be, in turn, inspired by the Taxonomy Regulation and its developing Delegated Act.

Furthermore, the mechanisms contemplated in the Taxonomy Regulation seem to be designed for bonds and bond-like products (financial instruments). How they may actually work as regards *physical* investments and schemes remains open.

Yet, as we also said in our paper, this conclusion is achieved by looking at green finance solely from the perspective of the ‘bad man’.[117] From that perspective, even if every cent that should be used for sustainable activities is so used, the EU would still be far away from achieving its transition. Yet, this could still underestimate the power of publicly led investment to change

[116] RRF Regulation, Article 24.
[117] Ramos Muñoz, Cerrato and Lamandini (n 115) 2-3.

the language and market 'social norms'. There is uncertainty in the language as to what is truly 'sustainable', and in the norms as to how acceptable are 'green' and 'brown' investments. If there is a massive (or even sizeable) chunk of green investments, this can help to achieve a common language of sustainability, which can then be used to change the expectations about the behaviour of public (and then private) issuers, which can then be used to change the normative expectations of market players. A broader consensus about what is normatively expected can, in turn, pave the way for more pungent, coercion-based mechanisms to be used against the hopeless cases, which can then reinforce the normative expectations. Thus, the uncertainties and limited size of NGEU's sustainable investments should not obscure the fact that their main impact may lie in changing the nature and content of the conversation.

5. A provisional conclusion

'A camel is a horse designed by a committee', so the cynical saying goes. Yet, the EU entered the COVID crisis needing a 'horse' in the form of a decisive response, which could overcome past tensions by looking into a more modern, digital, sustainable future; and, after going through several such 'committees' (if we broadly include the Commission, Council, EP, and national levels), NGEU still largely, refreshingly (and, to many, surprisingly), like a horse. Plenty could still go wrong, but there are reasons to believe that the EU can, in its own peculiar way, get things done. Thus, at the time of writing, we have the luxury of being able to criticise some aspects, or discuss what could be improved to ensure that the plan's 'humps' are smoothed over, instead of weeping over the 'n^{th}' missed opportunity, as we stare into the abyss.

To make sure that NGEU does not disappoint, it is important to have realistic expectations, which begin by properly understanding what the fund is and what it is not. It is a temporary measure, not a permanent one (which could lead to expect broader burden-sharing); it is not intended as a broad-based stimulus measure focused on consumption (which puts money into the citizens' pockets) but as a transformational measure focused on investment in specific areas; it is not an initiative fully directed by the EU, but largely delegated to the Member States through NRRP, which means that the Commission must approve, but the responsibility for their success largely lies at a national level; and it is also not the same as the InvestEU Fund, the centrepiece of the InvestEU Programme, which is instead aimed at supporting the objectives of EU internal policies, although with complementarities with the NGEU. In our view, NGEU should have also included fostering capital markets funding through equity lines or venture capital as one of its instrumental goals. However, adding one more constraint could have overloaded the proposal, and one must also acknowledge political realities.

Another aspect that needs to be understood is that, although the transformation and dynamisation of EU economies is the NGEU's ultimate goal, the procedures for its adoption are not particularly dynamic, as they are anchored in the Treaties, and national constitutional rules.

A final consideration is the potential of NGEU to give a boost to sustainable finance. There, it is important to understand the context. As an investor, the EU has an important role to play, but the size of its investment is still small compared with the size of capital markets. However, sustainable finance is also partly a language of expectations and duties: 'green' instruments need to be defined, and those definitions need to be tested through market practice in order to become the norm. In that respect, NGEU provides a uniquely large lab to test green bonds, which can then change the expectations about financial instruments across the board.

Like every experiment, NGEU offers plenty of uncertainties but also plenty of promise. Granted, Member States may still squander the opportunity with half-baked, more-of-the-same plans, but some may take advantage of the opportunity to come out of the crisis with a new normal. In any event, NGEU promises to be faithful to its ‘next generation’ name in making a decisive contribution to mainstream sustainability. Suppose it manages to do that, by finding the right balance and all needed transitory adjustments, accelerating digital and environmental transition without too abruptly disrupting the more traditional, path dependent, labour intensive pillars of our economies. In that case, it will be a visionary gate for the future.

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SECTION IV:
BANKING REGULATION

11. Releasability Combined Buffer Requirements after the COVID-19 pandemic

Bart Joosen

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1. Introduction

In my contribution 'Balancing macro- and microprudential powers in the SSM during the COVID-19 crisis' in the previous edition of this E-Book[1], I reflected on the extensive relief measures for banks in the form of the cancellation of, among other things, obligations regarding the combined buffer requirements (CBR) that have been introduced since the implementation of Basel III in Europe by means of the Capital Requirements Regulation (CRR)[2] and Capital Requirements

[1] Bart P. M. Joosen, 'Balancing macro- and micro-prudential powers in the SSM during the COVID-19 crisis' in Christos V. Gortsos and Wolf-Georg Ringe (eds), *Pandemic Crisis and Financial Stability*, (European Banking Institute, Frankfurt am Main, May 2020).

[2] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and

Directive IV (CRD IV)[3]. These measures came on the one hand from the European Central Bank (ECB) in its capacity as microprudential supervisor in the Single Supervisory Mechanism (SSM)[4], and on the other hand from the competent authorities in the several Member States (NCAs). All agreed at the time that these measures were introduced appropriately, prudently and in a timely manner. They should be one of the safeguards that banks would continue their fundamental role in the economy, and they were targeted on avoiding a credit crunch.

More than a year has passed since the relevant measures were taken in March 2020[5]. And there is significant debate about it,

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investment firms and amending Regulation (EU) No 648/2012 [2013] OJ L176/56.

[3] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC [2013] OJ L176/56.

[4] ECB, 'ECB Banking Supervision provides temporary capital and operational relief in reaction to coronavirus' (Press Release, 12 March 2020), bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200312~43351ac3ac.en.html.

[5] For a further elaboration on the decisions of March 2020, see Joosen (n 1) and furthermore (among many other publications): Edouard Fernandez-Bollo, 'European banking supervision measures in the context of the coronavirus (COVID-19) pandemic' Florence School of Banking & Finance Online debate (28 May 2020); Christos V. Gortsos, 'The response of the European Central Bank to the current pandemic crisis: monetary policy and prudential banking supervision decisions' (2020) 17 European Company and Financial Law Review 231-256; Matthieu Darracq Pariès et al., 'Enhancing macroprudential space when interest rates are low for long' (2020) ECB Macroprudential Bulletin - Article - No. 11 (19 October 2020), ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/ecb.mpbu202010_4~0cbde97c95.en.html; Luis de Guindos, 'Macroprudential policy after the COVID-19 pandemic' (Panel contribution, Banque de France/Sciences Po Financial Stability Review Conference 2021 "Is

and that debate is growing. Critics plainly use the wording that the measures have allowed banks to benefit from a bailout once again at the expense of taxpayers[6]. Contrary to expectations, the banking sector appears to remain spared from serious problems and significant solvency problems. Many banks, however, that picture is different in the Member States, seem to be able to weather the crisis more or less unscathed, and, completely counterintuitively, the forecast of (explosive) growth of the Non-Performing Loans (NPL) on the balance sheets of banks does not turn out to take place thus far. In fact, by the end of 2020, the percentage of NPLs on the balance sheets of European banks was at its all-time low.[7] Banks are swimming in liquidity, partly as a result of the ECB's monetary support operations and the most common explanation for the fact that banks can weather this crisis relatively well is the fact that European and national support measures for the 'real economy' seem to have given banks a break, at least for the time being.

Now it is too early to cheer and assume that the economic crisis will bypass the banking sector altogether. Right from the start

macroprudential policy resilient to the pandemic?", 1 March 2021), ecb.europa.eu/press/key/date/2021/html/ecb.sp210301~207a2ecf7e.en.html.

[6] Thierry Philipponnat, 'Bail out people, not banks' (*Finance Watch*, 15 February 2021), finance-watch.org/bail-out-people-not-banks; Thierry Philipponnat, 'Tackling non-performing loans in the aftermath of the Covid-19 pandemic' (Speech at the European Economic and Social Committee hearing, 15 February 2021), finance-watch.org/publication/tackling-non-performing-loans-in-the-aftermath-of-the-covid-19-pandemic.

[7] EBA, *Risk Dashboard – Data as of Q4 of 2020*, eba.europa.eu/sites/default/documents/files/document_library/Risk%20Analysis%20and%20Data/Risk%20dashboard/Q4%202020/972092/EBA%20Dashboard%20-%20Q4%202020.pdf (the non-performing loan (NPL) ratio decreased by 20bps to 2.6%). See also, Andrea Enria, 'NPLs in the euro area: progress so far and COVID-19 outlook' (Speech at ECB Banking Supervision, 19 May 2021), bankingsupervision.europa.eu/press/speeches/date/20 21/html/ssm.sp210519~84ac171a65.en.pdf.

of the COVID-19 crisis, the competent authorities (EBA, ECB and national authorities) have issued strong warnings about the negative consequences that could arise for banks in the risk of client defaults. Many banks have also taken significant provisions against the 2020 result, and some of the largest banks in Europe closed 2020 with marginal profitability.[8] However, the question is: when will the blow come to which banks will be exposed. Or will that blow not come at all?

The coherence of the European and national support measures and the resulting postponement of the problem for the banks, the December 2020 proposals of the European Commission on enhancing the secondary market for NPLs and the extent to which (in retrospect) it will be necessary to update the BRRD's toolbox (including the rules on pre-cautionary measures), the discussion of dividend payments and share-buy backs by banks to their shareholders' and the challenges banks made to the policy stance of the authorities to exercise restraint, the extent to which it was justified to postpone the introduction of IFRS9 for banks and other topics will be discussed in detail in other parts of this book.

In this contribution I want to reflect on the now frequently heard hypothesis that the functioning of the buffers as such, and in particular the countercyclical buffer, should be re-examined.[9] This reorientation has to do with those who study this more

[8] Douglas Kiarelly et al., 'Bank loan loss provisioning during the Covid crisis' BIS Quarterly Review (March 2021), bis.org/publ/qtrpdf/r_qt2103w.htm.

[9] See de Guindos (n 5) ('In short, the fact that only a tiny fraction of capital buffers has been explicitly releasable limited the macro-financial stabilisation function of macroprudential policy'. With this remark he refers to the fact that the countercyclical buffer only represented 0.2% of the risk weighted assets in the Eurozone by the end of 2019, and that releasing this buffer (which was done by only 6 to 7 Member States) resulted into a minimal impact).

closely pointing out that the countercyclical buffer, for example, was designed to serve as a buffer that had to fulfil a function in a typical cyclical economic development, while the COVID-19 crisis has taught that the consequences for the economy are anything but traditional. In this respect, the Basel Committee on Banking Supervision (Basel Committee) in particular is being looked upon to further examine the appropriateness of the buffer requirements and the functioning of the buffers.

What I wanted to investigate further is the circumstances and the concrete application of the release of the CBRs. Little has been written about this so far. We are all familiar with the brief explanation given by the ECB on the 'release' of the capital conservation buffer.[10] One point that is increasingly brought to the fore in the debate on macroprudential buffers is the limited scope for releasing these buffers as a result of a decision by the competent authorities (based on the division of competences under CRR/CRD IV, the NCAs are). This point is prominently put forward by De Guindos in his recent speech at the Banque of France symposium.[11] In short, in his opinion it means that only the countercyclical capital buffer in fact qualifies for a discretionary power on the part of the authorities to allow it to lapse or be less extensive.

Other buffers (referred to as the 'structural buffers') are in fact not reserved for the competent authorities, but for the institution itself to use them. This is particularly important for the capital

[10] See, for instance, Andrea Enria, 'The coronavirus crisis and ECB Banking Supervision: taking stock and looking ahead' (*The Supervision Blog*, 28 July 2021), bankingsupervision.europa.eu/press/blog/2020/html/ssm.blog200728~0bcbafb8bc.en.html.
[11] de Guindos (n 5).

conservation buffer. The paradoxical situation then is that while the authorities (in particular the ECB) communicated to the market on 12 March 2020 that exploiting the capital conservation buffer would be expedient in view of the economic crisis that could be expected, banks did not picked up this glove.[12] The explanation for this, according to De Guindos, is that banks are reluctant to push the limits of the automatic trigger of the Maximum Distributable Amount (MDA) process[13], because this would limit banks in their ability paying dividends or buying back capital instruments.

[12] Desislava Andreeva et al., 'Financial market pressure as an impediment to the usability of regulatory capital buffers' (19 October 2020) ECB Macroprudential Bulletin – Article No. 11, ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/ecb.mpbu202010_3~ece3267a72.en.html; Markus Behn et al., 'Macroprudential capital buffers – objectives and usability' (19 October 2020) ECB Macroprudential Bulletin – Article No. 11 ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/ecb.mpbu202010_1~01c4f1a5f4.en.html; Marcin Borsuk et al., 'Buffer use and lending impact' (19 October 2020) ECB Macroprudential Bulletin – Article – No. 11, ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/ecb.mpbu202010_2~400e8324f1.en.html.

[13] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC [2013] OJ L176/338 (see the provision of Article 141 CRD IV. The MDA process requires banks that are meeting the CBR to avoid distribution 'in connection with Common Equity Tier 1 to the extent that it would decrease its Common Equity Tier 1 capital to a level where the combined buffer requirement is no longer met.' For banks that fail to meet the CBR, a more complex process applies, which requires banks, in brief, to submit a 'distribution plan' defining the room in the profit that may be distributed ensuring that the combined buffer requirements are met. Such distribution plan is subject to the scrutiny of the competent authority and requires an approval for the planned distribution. Combined buffer requirements are these days a bit confusingly defined in Article 141a CRD IV to mean the sum of CBR, minimum capital requirements of Article 92 CRR and Pillar 2 Required capital add ons as

2. Timing of the release of the Combined Buffer Requirements (CBR)

As explained above, soon after the WHO declaration of a global pandemic, the European authorities issued a swift response and a comprehensive package of measures for the banking sector. The measures concerning the CBR were part of an extensive support package. Now it is almost inappropriate to ask out loud whether that quick response from the supervisory authorities was not too fast, it is also hindsight to make such a claim. The wisdom in hindsight lies mainly in the fact that at the time it was unforeseeable that there was great political will in Europe to come up with extensive support packages for the European real economy.

The size of these aid packages is unprecedented in the history of Europe, and by many hundreds of billions of euros exceeds the aid measures taken after the Global Financial Crisis (GFC) in 2008. It may be the memory of that traumatic time of the GFC and the concerns of the supervisory authorities about a repeat of the deep and almost unmanageable crisis that has forced the supervisory authorities to implement the package of measures at an early stage. At the same time, there is also a consensus, even though some (political) corners still disdain this, that the banking sector is in a considerably better position in 2020 than was the case before the GFC, partly due to the tightening of the

regulated in Article 104 CRD IV. In the original text of CRD IV, combined buffer requirements simply referred to, in accordance with its definition in Article 128 CRD IV as the sum of the capital conservation buffer of Article 129 CRD IV, the countercyclical capital buffer of Article 130 CRD IV, the systemically important institutions buffer of Article 131 and the systemic risk buffer of Article 133 CRD IV).

requirements as a result of Basel III which precisely aimed to make banks more resilient to external shocks.

And if it is not disdain for the results achieved by the banking sector, then it is incorrectly framing the measures taken by the ECB and the NCAs in spring 2020. Under the heading 'forbearance', Boot et al.[14] discuss the various measures in a way as if there was a (strong) deviation from the rules whereby supervisors 'accept temporary breaches of regulatory capital requirements'. I am against such framing. By nature, the measures taken in spring 2020[15] are no more or less than applying the rules in force in Europe since 2014 which implemented Basel III[16].

The CBR rules, among others, are fundamentally designed to be used in the macroeconomic cycle. The scope provided by these rules is intended to achieve a dynamic application of capital

[14] See Arnoud Boot et al., 'Coronavirus and banking: Evaluating policy options for avoiding a financial crisis' (*VoxEU CEPR*, 25 January 2021) voxeu.org/article/coronavirus-and-banking-evaluating-policy-options-avoiding-financial-crisis.

[15] The reader will note that in my comments below I do draw attention to the fact that it is doubtful whether the NCAs have turned the right knobs. That is not to say that the system as such would prohibit the use of the CBR to function as a macroprudential tool, but on a detailed level I think it would have been wiser to push the right buttons instead.

[16] Perhaps with one exception, where the ECB allowed banks to anticipate on the compliance with Article 104 a (4) CRD IV as regards the capital instruments that may be used to meet the Pillar 2-Required capital requirements already in 2020 where this provision only entered into force on 1 January 2021. In other words, the concession here was that the ECB allowed banks to apply a law that yet had to come into force six months later but was already part of an adopted and politically agreed upon legal provision in Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures [2019] OJ L150/253.

requirements, not a static application. In other words, the rules have been applied during the first months of the COVID-19 crisis by the regulators in the way for which they were intended. In my opinion, there is no talk of 'generosity' by the regulator. Boot et al. subsequently argue[17] that this 'forbearance' creates 'moral hazard', because banks have the expectation that if the (economic) conditions deteriorate, the banks will come to the rescue, with the result that banks will be inclined to take more risk, etc. In my opinion this analysis ignores the contemporary framework for banking supervision.

What I also do not understand very well is that the comments sometimes resonate that the measures taken in the context of the implementation of Basel III, and the strengthening of the capital buffers, were not intended to create resilience of banks against the type of crisis that arose after the COVID-19 outbreak. In other words, when designing the standards at the time, the Basel Committee would not have foreseen that an economic crisis could also arise as a result of a pandemic, and for that reason the standards adopted by the Basel Committee in 2010 are not suitable to tackle the crisis caused by COVID-19. In my opinion, however, the rules on the CBR in Basel III are neutral when it comes to the type of economic crisis, and not, as is

[17] This reasoning is a customary pattern in contemporary economic literature, and I sometimes wonder what the cause of the great detachment of economists from the reality of the current regulatory framework is. This is problematic, because the authoritative opinions of economists are often echoed in the political debate and, more widely, in the establishment of public opinion. I believe that this is one of the syndromes that have arisen because of the extreme complexity of the legislation and regulations. Banking law has gradually become a mandarin science, and I sometimes wonder whether this is not a fundamental problem. Legislation must be effective, and the standards must be understood by those who must work with those standards. This also applies to economics.

sometimes stated in the current debate, solely aimed at tackling problems in a 'traditional crisis'.[18]

What do the current rules say about the timing of 'releasing' CBRs? For this the relevant rules as contained in the current provisions of Articles 128 *et seq* CRD IV must be explored. I will read the language contained in the directive as amended pursuant to the amending directive CRD V of 2019[19] assuming full implementation of this directive in all the member states in the Eurozone[20] (Member States). It is fair to say that the provisions regulating the CBRs have undergone considerable change as a result of CRD V with effect from 1 January 2021. But this is not the case as regards the subject matter of the technical definitions and operation of the CBRs. Rather these amendments related to the embedding of the Pillar 2 Required (P2R) and Pillar 2 Guidance (P2G) rules and the relationship of CBRs in the context of determination of capital requirements pursuant to P2R and P2G and, ultimately, the functioning of the so-called capital conservation measures and MDA rules of Articles 141 *et seq* CRD IV.

To anticipate on the detailed discussion of the triggers defined in the regulation for the 'release' of one or more CBRs, I already set out here that there is no clarity in the current law on that subject matter. Rather the current rules precisely determine the triggers for establishing CBRs (meaning the point in time that a

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[18] I noted these comments during a debate at the online seminar at Financial Risk and Stability Network, 'Discussions@FRS – run#1' (Berlin, 19 May 2021), financial-stability.org/discussion-run-1.

[19] See Directive (EU) 2019/878 (n 16).

[20] The scope of this analysis is restricted to matters of the SSM and the roles of the ECB and the NCAs in the context of the SSM.

bank must comply with CBRs), but the rules as to the releasing such CBRs are rather thin and not precise.

3. Capital conservation buffer (CCB)

The CCB is set at 2.5% of the total risk exposure amount calculated in accordance with Article 92(3) CRR (TREA) to be maintained with common equity tier 1 capital (CET1). The CCB requirement was first applicable from 1 January 2016 but on the basis of a phased introduction. In 2016 the CCB rate was set at 0.625%, for 2017 at 1.25%, for 2018 at 1.875% and for 2019 at 2.5% (this is the year that the CCB was to be met on a fully loaded basis).[21] The CCB rules are therefore not shaped to apply to banks based on a trigger or the occurrence of specific external circumstances or the specific situation with the bank.

The CCB applies as a default requirement for any bank, small or large, whether operating on a cross border basis or not, whether upholding a simple business model or not and no matter the external macro-economic circumstances applicable. The CCB is therefore for instance not targeted at creating a mechanism for banks to build up the CCB once certain macroeconomic circumstances occur or if there is a specific exogenic sector wide reason (for instance the building up of specific systemic risk within the financial sector of the Member State).

As the CCB level is determined at 2.5% of TREA, this means that the absolute number of the buffer requirement shall be moving with the total outstanding number of TREA, if this amount of the denominator of the capital ratio increases, the

[21] See n 13 (the transitional provision for the CCB is set out in Article 160 CRD IV).

buffer requirement of the numerator of the capital ratio will increase in absolute sense, if TREA decreases, the buffer number will also decrease in absolute sense.

The CCB is sometimes referred to as a buffer enabling banks to build up capital in good (economic) times to be available in bad (economic) times. Its rationale can, however, hardly be derived from the text of the European legislation. To discover its purpose, the original standards of the Basel Committee must be read.[22] In respect of the CCB the BCBS determined:

> 'At the onset of the financial crisis, a number of banks continued to make large distributions in the form of dividends, share buy backs and generous compensation payments even though their individual financial condition and the outlook for the sector were deteriorating. Much of this activity was driven by a collective action problem, where reductions in distributions were perceived as sending a signal of weakness. However, these actions made individual banks and the sector as a whole less resilient. Many banks soon returned to profitability but did not do enough to rebuild their capital buffers to support new lending activity. Taken together, this dynamic has increased the procyclicality of the system.
>
> To address this market failure, the Committee is introducing a framework that will give supervisors stronger tools to promote capital conservation in the banking sector. Implementation of the framework through internationally agreed capital conservation standards will help increase sector resilience going into a downturn and will provide the mechanism for rebuilding capital during the economic

[22] Bart P. M. Joosen, 'The definition of default' in Bart P M Joosen, Marco Lamandini and Tobias H Tröger (eds), *Capital and Liquidity Requirements for European Banks* (Oxford EU Financial Regulation Series, OUP, forthcoming).

> recovery. Moreover, the framework is sufficiently flexible to allow for a range of supervisory and bank responses consistent with the standard'.[23]

The reader will notice that the Basel Committee mainly frames the introduction of the CCB in the context of the practices surrounding the payment of dividends during circumstances where early warning signals about an approaching economic recession (or as in the years 2008 and 2009 even in the circumstances that the crisis was already manifest) were insufficiently taken up by the banking sector as a whole to achieve capital reinforcement for the expected losses in view of the further economic downturn. In other words, this mainly concerns a bank governance problem and a problem surrounding the relationship of banks with their investor base, where the philosophy of the Basel Committee is that introducing a sector-wide additional buffer should help bank boards to conserve the capital structure, instead of eroding it.

Except as may be derived from its name, 'capital conservation', the CCB rules are not distinctly and precisely describing the release mechanisms of this buffer type. In fact, there is a negative 'trigger mechanism' applicable, where the use of the CCB by banks adds up to the circumstances that a bank may not (fully) distribute dividend, pay variable remuneration or pay coupon on Additional Tier 1 capital instruments (AT1). The basis for this mechanism can be found in paragraph 5 of Article 129 CRD IV that states:

[23] Basel Committee on Banking Supervision, 'Basel III: A global regulatory framework for more resilient banks and banking systems' (December 2010 [revised June 2011]), bis.org/publ/bcbs189.pdf (see paras 27 and 28 on Basel III-Capital).

> ‘Where an institution fails to *fully* (emphasis, BJO) meet the requirement set out in paragraph 1 of this Article, it shall be subject to the restrictions on distributions set out in Article 141(2) and (3)’.

The reference to the provisions of Article 141(2) and (3) CRD IV is to the MDA rules, which strictly regulate the circumstances in which banks must submit to the competent authority a distribution plan[24] determining the ‘room’ in the distributable amounts of profit considering the CBR, minimum capital requirements and P2R as is set out in Article 141a CRD IV. The way the application of the MDA rules is defined in Article 129(5) CRD IV, suggests that even a minimal underscoring of the CCB results into the application of the MDA rules. For the sake of reasoning, even if a bank would underscore the CCB with 10 basis points, the consequence is, as things are now drafted in the legislation, that the restrictions of dividend distribution, variable remuneration and AT1 coupon apply to the fullest extent.

On this basis, it can be concluded that while the CCB's very first line of thought was in fact intended to provide a bank with the flexibility to have an additional buffer in a deteriorating economy that can be freely used to absorb the expected losses, it’s principle incorporated in the legislation has in fact become a freezing mechanism: banks will want to prevent at any price from not complying (even with the smallest amount) with the CCB, because this automatically (see: Article 129 (5) CRD IV) leads to the necessary application of the MDA process.

From this perspective, the CCB cannot be used as a mechanism to relieve the bank of capital requirements, so that released

[24] See (n 13) (the rule set out in Article 141 (2) CRD IV).

capital (the difference between the available capital and the required capital) can be used for (new) lending.[25] One may even wonder whether the CCB currently belongs to the macro-prudential toolkit of the competent authorities. After all, the buffer mechanism does not allow 'twisting the knobs', for example if macroeconomic or systemically relevant developments require this. In fact, the CCB acts as a quasi-capital requirement in addition to the minimum capital requirement of Article 92 CRR. Let me put it another way, it would not make much difference to the functioning of the CCB whether the provision of Article 92(1)(a) CRR states that the CET1 ratio should be at least 7% instead of the current one 4.5% and then the 129 CRD IV scheme would not have been necessary.

In conclusion, as things currently stand, the CCB is hardly suitable to serve as a buffer that can be released if banks intend to use the release of the capital requirements for new loans. Rather, the CCB functions as a mechanism to allow the competent authorities to influence the dividend policy of banks, so that banks, if they intend to maintain the confidence of the investor base, will not be much in favour of using the CCB. They will see this buffer as a quasi-Pillar 1 requirement for minimum capital, whereby it will be taboo to come close to undershooting those minimum capital requirements.

4. Countercyclical capital buffer (CCyB)

In recent discussions on the releasability of CBR, it has become prominent that it specifically identifies the CCyB as suitable, or currently the only one in the CBR that can be released based on

[25] See in a similar sense: Behn et al. (n 12) 10; de Guindos (n 5).

the discretion of the relevant authorities. Release of the CCyB then frees up capital of the bank, which enables the bank to extend credit granting to support the real economy. It pre-supposes that a sufficient CCyB is being built up, so release of it can have a meaningful impact.

Is this not in conflict with the original purpose of the CCyB as it was designed where an increase in the CCyB is primarily intended to slow the build-up of credit or 'lean against the [cyclical] wind'? It is on the one hand correct to say that this is identified only as a possible side benefit by the Basel Committee.[26] This side effect purports to build up the CCyB as macroeconomic conditions indicate that there is a potential overheating of the economy and the CCyB therefore has the function of slowing down lending. But side effect or not, the design of the CCyB as a true macroprudential tool must be assessed against this element of the framework. Nowadays the prevailing opinion on the function of the CCyB is explained by the Basel Committee as follows:

> 'The countercyclical capital buffer aims to ensure that banking sector capital requirements take account of the macro-financial environment in which banks operate. Its primary objective is to use a buffer of capital to achieve the broader macroprudential goal of protecting the banking sector from periods of excess aggregate credit growth that have often been associated with the build-up of system-wide risk. Due to its countercyclical nature, the countercyclical capital buffer regime may also help to lean against the build-up phase of the credit cycle in the first place. In downturns,

[26] See Katarina Stojkov, 'Different Approaches to Implementing a Countercyclical Capital Buffer' (17 September 2020) Reserve Bank of Australia, Bulletin 113-121, rba.gov.au/publications/bulletin/2020/sep/pdf/different-approaches-to-implementing-a-countercyclical-capital-buffer.pdf.

> the regime should help to reduce the risk that the supply of credit will be constrained by regulatory capital requirements that could undermine the performance of the real economy and result in additional credit losses in the banking system'.[27]

While the discussion unfolds on the suitability of the CCyB as a buffer that could be released on the basis of a discretionary decision of the authorities, the same discussion also emphasises that there may be a need to arrive at a flat-rate buffer rate that should apply throughout the banking system in the Eurozone. This point was made after it was found that there has been very limited application of the CCyB in the different Member States (in fact, this buffer has only been activated in about half of the Member States, while a number of Member States were just started the process to enter the CCyB). On average, the CCyB only counted for 0.1% of the total of the average capital ratios.[28]

What should be kept in mind here is the way in which the CCyB is implemented in the current rules of CRD IV. These rules provide significant information on how the CCyB can be introduced, who the competent authorities are, and the phasing in of the applicable buffer requirements. But what the current regulations do not clarify is the procedure to be followed when to 'release' the CCyB and the reasons for the release. In other words, there is a fairly complex set of rules for setting up the buffer, but not for its release, and the resulting lower capital requirements, which in turn would have to help banks to provide

[27] Basel Committee on Banking Supervision, 'Countercyclical capital buffer (CCyB)' (18 December 2020), bis.org/bcbs/ccyb.

[28] See Behn et al. (n 12) 12; de Guindos (n 5) ('The imbalance between cyclical and structural buffers has gained more attention in the macroprudential debate since the beginning of the pandemic. There seems to be a growing consensus on the need to reassess the current balance between structural and cyclical buffers and to create more macroprudential space that could be used in a system-wide crisis if needed').

credit to the 'real economy'. In the following I wanted to briefly summarise the rules as they now stand, but I immediately make the reservation that a detailed description of the very complex European rules would merit a more extensive analysis.

Unlike the CCB, the CCyB is an institution specific buffer. This results from the definition included in Article 128(7) CRD IV and the provision of Article 130 CRD IV. The determination of the CCyB (the rules on 'setting' the CCyB by the competent authorities) is based on the provisions of Articles 136 or 137 CRD IV. In addition, it is possible that a third-country authority formulates requirements with regard to the CCyB for exposures that the bank has in that third country. I will not discuss this issue further in this contribution (the determination of the CCyB rates for cross-border activities outside the EU). The institution specific CCyB is to be held both at individual and consolidated level, measured against the TREA multiplied by the weighted average of the CCyB rates calculated in accordance with Article 140 CRD IV.[29]

What is now a complicating factor for the interpretation of the CCyB 'releasability' phenomenon in the context of the point discussed in this contribution, concerns the system laid down in the European rules with regard to determining the CCyB rates and the methods to be applied in that context. This system is based on a framework, in which the European Systemic Risk Board (ESRB) has an important role to play in providing advice to the competent authorities regarding the CCyB rates to be determined by them on a discretionary basis. In other words, the advice of the ESRB should colour the decisions of the national competent authorities. There should be a clear relationship, with

[29] See (n 13) (Article 130(1) CRD IV).

the recommendations of the ESRB and the setting of the CCyB for the conditions identified in certain Member States (by the ESRB).

I have already indicated that the current interpretation of the nature and operation of the CCyB is not necessarily exclusively related to the 'leaning against the wind' principle, the use of capital requirements to slow down lending due to an undesirable macroeconomic development (excessive credit growth). However, when one now consults the relevant provision of Article 135 CRD IV, in which the system and the competence of the ESRB is given, one sees many traces of that 'leaning against the wind' principle. For example, the provision in Article 135(1)(c) CRD IV, which states that the ESRB should give guidance to the competent authorities:

> '[…] on variables that indicate the build-up of system-wide risk associated with periods of excessive credit growth in a financial system, in particular the relevant credit-to-GDP ratio and its deviation from the long-term trend, and on other relevant factors, including the treatment of economic developments within individual sectors of the economy, that should inform the decisions of designated authorities on the appropriate countercyclical buffer rate under Article 136'.

Unmistakably, this is related to the idea of the function of capital requirements to combat excessive lending that can contribute to overheating of the economy, in other words, it determines the circumstances in which the deployment of a CCyB is more likely to reduce the amount of credit to the economies, then that there should be application of the CCyB as a method to encourage banks to continue or pick up credit when the CCyB is released.

This principle is then subsequently confirmed in the framing of the tasks and responsibilities of the competent authorities in Article 136 CRD IV. The core provision determines the following:

> ‘2. Each designated authority shall calculate for every quarter a buffer guide as a reference to guide its exercise of judgment in setting the countercyclical buffer rate in accordance with paragraph 3. The buffer guide shall reflect, in a meaningful way, the credit cycle and the risks due to excess credit growth in the Member State and shall duly take into account specificities of the national economy. It shall be based on the deviation of the ratio of credit-to-GDP from its long-term trend, taking into account, inter alia:
>
> (a) an indicator of growth of levels of credit within that jurisdiction and, in particular, an indicator reflective of the changes in the ratio of credit granted in that Member State to GDP;
>
> (b) any current guidance maintained by the ESRB in accordance with Article 135(1)(b).
>
> 3. Each designated authority shall assess the intensity of cyclical systemic risk and the appropriateness of the countercyclical buffer rate for its Member State on a quarterly basis and set or adjust the countercyclical buffer rate, if necessary. In so doing, each designated authority shall take into account:
>
> (a) the buffer guide calculated in accordance with paragraph 2;
>
> (b) any current guidance maintained by the ESRB in accordance with Article 135(1)(a), (c) and (d) and any recommendations issued by the ESRB on the setting of a buffer rate;

> (c) other variables that the designated authority considers relevant for addressing cyclical systemic risk'.

Thus, this is the basis of the establishment of the CCyB, and there are equally rules for the release of the CCyB under the same rules, and the release of the CCyB is clearly related to the macroeconomic developments within the relevant Member State, authorities perceived a need to relaunch credit that had slowed down with the establishment of the CCyB for the Member State concerned.

It is also important to mention that the fundamental mechanism of the CCyB involves phasing in its application and its release. There are strict rules whereby the authorities must disclose to the market and industry the launch of policies regarding changes in the CCyB rate, on a quarterly basis, whereby the introduction or phase-out of the CCyB, or the raising or lowering of the applicable percentages between 0% and 2.5% must be announced, but where the disclosed arrangement must not have immediate effect. In addition, if the CCyB is lowered or set to 0% completely, there is also an obligation, albeit not to meant to be absolute binding, under Article 136(6) CRD IV to provide an indication of the period in which no increase in CCyB is expected.

That system of gradual introduction, but especially the gradual release of the CCyB, has been abandoned on the occasion of the COVID-19 measures. The measures taken by the NCAs in March 2020 have had immediate effect in most cases, except in those Member States (such as France) where there was an intention to introduce the CCyB over time, in other words the increase by those Member States of the applicable 0% rate to a higher level; in those cases, the announcement by the relevant

NCA that it will not make that implementation has obviously had no effect on the release of capital requirements.

By going into detail about the backgrounds and the system of the CCyB, I aim to find an explanation for the relatively limited application of this part of the CBR in the Member States. Is the conclusion justified that the Member States applied the CCyB in accordance with the original design and rules of CRD IV, in the sense that the macroeconomic conditions in the relevant Member States dictated the application of the CCyB? In other words, the limited application of the CCyB in Europe by its very nature may be explained by the fact that not all Member States had yet experienced the threat of overheating of the economies, which has led the NCAs to be reluctant to introduce this buffer. If this is the explanation, then the interpretation in the current debate of the usefulness of the CCyB, and especially the notes of some that only a disappointing amount of that CCyB could be used for the support measures in the COVID-19 crisis is not very easy to follow, and even less the plea for a 'flat rate' for the whole of Europe. The latter would be very contradictory to the essence of the CCyB rules and should therefore (should) entail a radical change of the system.

After all, the introduction of a flat rate (to be imposed ex ante) means that the specific macroeconomic conditions in the Member State concerned are thereby ignored, a CCyB is applied, as it were, regardless of the state of the macroeconomic cycle, also in cases in which the cycle would justify banks continuing to provide financing to keep the economy going, a flat rate will undoubtedly make banks less able to fulfil that role, it by its very nature leads to the increase in cost-to-capital and Return on Risk Weighted Assets (RORWA), which are not good incentives to continue lending.

A flat rate does indeed completely set aside 'leaning against the (cycle) wind', but as explained above, this is a not insignificant foundation that stood at the cradle of the design of the European rules. And furthermore, does a flat rate lead to an undesirable absolute increase in the CBR? Whatever the outcome of the discussion regarding the rebalancing of the structural and cyclical buffers, there are by nature, in my opinion, no reasons for achieving an absolute increase.[30]

5. Systemically important institutions buffer (G-SIIB and O-SIIB)

There has also not been much discussion about the use of another (structural) buffer, the systemically important institution buffers, in the context of combating the economic recession that was expected after the outbreak of the COVID-19 crisis. Nevertheless, a number of Member States have opted to use the so-called G-SII[31] or O-SII[32] buffers for this purpose.[33] I am surprised this happened. In particular, the rules of CRD

[30] In similar terms, see de Guindos (n 5) ('First, the creation of macroprudential space should be capital-neutral. In other words, it should be achieved by amending or rebalancing certain existing buffer requirements rather than by creating additional buffer requirements for banks').

[31] Capital Requirements Regulation (CRR): 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 and amending Regulation (EU) No 648/2012 [2013] OJ L 176/1 (G-SII stands for Global Systematically Important Institution as defined in as defined in point (133) of Article 4(1) CRR which references back to the classification system of Article 131 CRD IV).

[32] ibid (O-SII stands for Other Systematically Important Institution as follows from the combination of the definition of Article 4 (1) (133) CRR and the system of Article 131 CRD IV).

[33] See ECB Banking Supervision, 'Combined buffer requirements as of 2 April 2020 in countries subject to ECB Banking Supervision' (22 April 2020); Joosen (n 1).

IV[34] are clear when it comes to the circumstances under which the relevant buffers can be released, and that is the case if the relevant systemically important banks no longer qualify as such, either that due to contraction or divestiture of certain specific activities that weigh heavily in the bucket classification for 'interconnectedness', or because of an increased chance that the activities are replaceable by a competing bank or such circumstances will end up in a lower systemically important bucket classification. By their very nature, the setting-specific G-SII and O-SII buffers are, in my opinion, not suitable to be used to release capital requirements, in the context of stimulating the economy.

The provisions of Article 131(10) and (12) CRD IV develop a clear mechanism as to the potential release of the G-SII or O-SII buffers, involving the ESRB in pre-notifications of the intentions by the NCA to do so, the ESRB on its turn should involve the European Commission and the EBA in this process. The system is explicitly not based on a sudden release, but a gradual introduction and phase-out in a fixed annual cycle in which the relevant banks are evaluated to what extent they meet the criteria for a G-SII or O-SII, and the whole procedure is embedded assuming that there is a review by the European authorities (ESRB, European Commission and EBA) of the relevant policy intentions of the NCA. All this, as far as I have been able to observe, was not taken into account in March 2020 when the relevant Member States turned the knobs of the respective buffers.

It seems to me that this must also have been confusing for the financial markets. After all, a bank is systemically important, or

[34] See (n 13) the provisions of Article 131 CRD IV.

it is not, and that systemic importance justifies higher capital buffers. Can the release of such buffers then be interpreted as the judgment of the relevant NCAs that the banks can no longer be regarded as systemically important? That could not have been the intention of these measures taken in the spring of 2020.

It is perhaps those events that have made the ECB make the critical notes that there is a need for a better coordinated approach in the SSM[35], a point I wholeheartedly agree with. It seems to me that the most important discussion we must have in the coming period should be about whether, in view of the foundation of the SSM, there is not a dire necessity to transfer the original choices regarding the distribution of competences in the application of the CBRs to the central supervisor, and as far as I am concerned this will apply to both the significant institutions and the less significant institutions.

6. Systemic risk buffer (SRB)

It is also striking that the possibilities offered by the systemic risk buffer (SRB) for the NCAs to vary the rules applied have not been used on a larger scale. In my view, the SRB is pre-eminently a macroprudential tool that is specifically aimed at controlling systemic risks that develop as a result of macroeconomic developments. In other words, in the event of expected changes in macroeconomic conditions, will there also be reason to review the impact on systemic risks? However,

[35] Admittedly, one must read between the lines, but, for me, the following notes of de Guindos (n 5) are clear enough: 'Second, the additional macroprudential space created in this way needs to have strong governance in order to ensure that capital buffers are released in a consistent and predictable way across countries when facing severe, system-wide economic stress'; de Guindos (n 36).

hardly any use has been made of the possibilities to vary the SRB, which has been limited to two Member States.

The SRB is laid down in Articles 133 and 134 CRD IV. The buffer is a specific arrangement for European banks that has no basis in the standards of the Basel Committee. The buffer is intended:

> 'to prevent and mitigate macroprudential or systemic risks not covered by Regulation (EU) No 575/2013 and by Articles 130 and 131 of this Directive, in the meaning of a risk of disruption in the financial system with the potential to have serious negative consequences to the financial system and the real economy in a specific Member State'.

For this text, see the provisions of the first paragraph of Article 133 CRD IV. The buffer is rather intended to have a sector-wide application or to tackle problems in parts of the markets. In other words, the SRB is not intended for application at the level of the individual institution, it is sector specific. With regard to the latter, in most of the Member States that have applied it, the SRB is mainly related to the real estate sector, in other words the SRB applies to any bank in that jurisdiction engaged in real estate financing. If a bank is not involved, the SRB does not apply for that reason.

The system of application of the SRB, but also the relationship to the G-SII and O-SII whereby the SRB is applied cumulatively to the relevant bank (see Article 131(15) CRD IV) is a complex arrangement. This means that NCAs have to a certain extent the discretionary freedom to apply the SRB in the cases mentioned in Article 133 CRD IV and for the reasons mentioned in that provision, but that freedom is limited to 3%.

In addition, the NCA will have to apply a complicated procedure with a large involvement of the ESRB, the European Commission and the EBA. It is a procedure that has similarities with the heavy regulation of Article 458 CRR. It could be said that setting an SRB of more than 3% (as is the case for Article 458 CRR) is a last resort, severely restricting the NCA's discretion.

Article 133(9) CRD IV expressly foresees the possibility that the NCA decides to reduce the SRB. A notification procedure to the ESRB applies for this. That provision provides criteria that such notification must meet, but they are written for the ‘activation’ of the SRB (or increase of an existing SRB rate), rather than describing on what grounds that SRB can be reduced or even on 0% can be set. The relevant ‘activation reasons’ are:

> ‘(a) the macroprudential or systemic risks in the Member State;
>
> (b) the reasons why the dimension of the macroprudential or systemic risks threatens the stability of the financial system at national level justifying the systemic risk buffer rate;
>
> (c) the justification for why the systemic risk buffer is considered likely to be effective and proportionate to mitigate the risk;
>
> (d) an assessment of the likely positive or negative impact of the systemic risk buffer on the internal market, based on information which is available to the Member State;
>
> (e) the systemic risk buffer rate or rates that the competent authority or the designated authority, as applicable, intends to impose and the exposures to which such rates shall apply and the institutions which shall be subject to such rates;
>
> (f) where the systemic risk buffer rate applies to all exposures, a justification of why the authority considers that

> the systemic risk buffer is not duplicating the functioning of the O-SII buffer provided for in Article 131'.

Therefore, in order to apply this scheme (which is mandatory under the last subparagraph of paragraph 9 of Article 133 CRD IV), the relevant NCA will have to include the mirror image motifs in the notification to the ESRB, e.g., why the macroprudential circumstances justify a revision of the applied SRB rate. But by its nature such justification should not be impossible. In fact, the COVID-19 crisis has shown that such justifications can be easily developed, given the events in the European economies as we have seen them at the time.

However, the relevant provisions do not attach a complex phasing-out arrangement to the reduction of the SRB, as is in fact the case for the CCyB, which in my opinion makes the SRB much better suited to rapid shifts in requirements, by its very nature an SRB can be imposed with immediate effect, or scaled down according to the circumstances.

7. Final remarks

In my country there is a saying 'the best helmsmen are ashore'. It is of course very easy from the chair of scholarly research to criticise the way the rules have been applied during the COVID-19 crisis. Let me start with that caveat before coming to the concluding remarks.

I would be in favour of recalibrating the CBR rules, but the modifications I recommend should not lead to a revision of the CCyB's system, or of the structural buffers CCB, G-SII, O-SII or SRB as such. I think we should be careful not to resort to very radical interventions again in a system that by its very nature has existed for less than ten years. The practical test of the system during the COVID-19 crisis does show that better control might be needed regarding the application of the existing rules. In doing so, I could envisage new to be developed Regulatory Technical Standards regarding the 'establishment and release' of the CBR, a task that I believe would be best assigned to the EBA.

At the same time, I think that for the SSM area, there is a need to think about the organisation of the powers regarding the application of these macroprudential instruments, I would not be opposed to transferring all of that to the ECB. Here the reader will be able to read an echo of the points I have made in my contribution to the first edition of this book.

The most radical change I could imagine in the recommendations in this contribution concerns the creation of an amended regulation for the capital conservation rules, the framework included in Article 141 *et seq* CRD IV. Now that is obviously the most controversial issue in this context. Because the rules on MDA, mainly because of the extension of the rules for regular microprudential supervision to a system in which the resolution authorities must also get a grip on the dividend policy of banks in the context of the formation of sufficiently robust MREL levels, only recently changed on the occasion of the CRD V rules.

Nevertheless, and here again I refer to the words of De Guindos[36], I see the scope for releasing capital more in the CCB

[36] de Guindos (n 5) ('The capital conservation buffer would be a natural candidate for creating macroprudential space if it was made releasable in a context where these principles were adhered to. Specifically, the possible release of the capital conservation buffer in a system-wide crisis should be centrally governed in the euro area and could be combined with dividend restrictions in order to maintain equivalence with international standards').

than in tilting the CCyB or G-SII and O-SII buffers. The new wording of Article 129 CRD IV that has been introduced with CRD V regarding the automatic trigger of the MDA mechanism if the CCB is underscored by even the smallest number, prevents the use of that buffer by the banks, for the reasons set out in the paragraphs above. It might then perhaps be useful to revise the wording of the provision of Article 129(5) CRD IV so that instead of the current wording, the provision reads as follows:

> 'Where an institution *reaches the point that it fails to meet 50% (*emphasis, BJO, to display the recommended change*)* of the requirement set out in paragraph 1 of this Article, it shall be subject to the restrictions on distributions set out in Article 141 (2) and (3).'

Redefining it in this way creates 125 basis points of room for banks to use the CCB, without immediately leading to an MDA mechanism being applied. It is that space that could be useful to avoid a credit crunch that is mainly based on market expectations about the resilience of banks, and it prevents an absolute freeze of flexibility for banks. The proposal I have made therefore preserves the essence of the existing buffers. It still obliges banks to build up the CCB in good times but using that buffer to half in bad times does not lead to the in its nature significant consequences for banks. Using 125 basis points of the CCB would in my proposal not force banks into an 'intensive care' situation with their supervisor if the MDA rules must be followed. Currently, in case the bank is not 'fully' meeting the CCB requirements as the language of Article 129(5) CRD IV is now phrased, such automatic application of the MDA rules is the reality.

For the sake of completeness, I should note that De Guindos explicitly sees no room to let go of the MDA principles, as I have advocated above. Although he sees room to use the CCB, at the same time he believes that there is reason to link this to a robust policy regarding dividend payments. I am concerned that would not have any obvious effects. In essence, De Guindos is saying that banks should be free to use the CCB, but that this does lead to application of the MDA principles. But that is currently already the case, we do not have to recalibrate the rules for that.

It will, having weighted everything, boil down to the fact that regulators must be actually comfortable with the levels of CET1 currently held by the banks, and that those levels can absorb a cut of 125 basis points, without banks being subjected in those cases to the strict rules of MDA. This gives the banks more leeway to also take into account the interests of investors and the capital markets in general, especially now that it is extremely difficult for European banks to raise new capital as a result of the current framework. If the proposition is to the financial markets: banks can on the one hand make use of the macroprudential leeway included in the design of the rules in the CBR, but on the other hand, if that space is used, they end up in a special arrangement that will prevent them from having to pursue a reasonable dividend policy, I am afraid that the current problem of undervaluation of European banks and the difficulties they experience in raising new capital will not be resolved quickly.

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12. Restriction for bank capital remuneration in the pandemic: a lesson for the future or an outright extraordinary measure?

Antonella Sciarrone Alibrandi and Claudio Frigeni[*]

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1. General overview

Since the outbreak of the COVID-19 pandemic, a number of different approaches and pressures have been brought to bear on companies aimed at discouraging, and even prohibiting, dividends distribution and shares buyback[1].

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[*] This article was completed on 31 May 2021. No account could be taken of developments since that date.

[1] For a general overview, see Antonella Sciarrone Alibrandi and Claudio Frigeni, 'Restrictions on Shareholder's Distribution in the COVID-19 Crisis:

Although varying in form and manner, this trend has similarly emerged in almost every jurisdiction and has involved any economic sector, including, in a particularly pervasive way and with some peculiarities, the financial one. Supervisory authorities worldwide have taken measures aimed at preventing banks (but also insurance companies[2] and other financial intermediaries) from making distributions in order to enhance their ability to continue to support the real economy.

Together with monetary and fiscal policy interventions, regulatory and supervisory actions have been aimed at mitigating the impact of the pandemic on bank lending capacity. To that end, banks were asked to use capital buffers to absorb losses and, in addition, were granted capital relief in various forms.[3]

Against this background, with regard to banks operating in the EU financial sector, the pressure to avoid dividends distribution and shares buy-back has been advanced as of March 2020 by several authorities, that, even with no formal introduction of a legal ban, expressly encouraged banks to suspend at least

Insights on Corporate Purpose' in Christos V. Gortsos and Wolf-Georg Ringe (eds), *Pandemic Crisis and Financial Stability* (EBI 2020).

[2] Similar measures were also taken with regard to the insurance sector: see the EIOPA's Statement on actions to mitigate the impact of Coronavirus/COVID-19 on the EU insurance sector of 17 March 2020 and the EIOPA's Statement on dividends distribution and variable remuneration policies in the context of COVID-19 of 2 April 2020, that have been followed by specific statements by the national competent authorities of the Member States, as well as of an analogous statement by the UK Prudential Regulation Authority.

[3] See Giovanni Bassani, 'Of Viruses, Economic Crises and Banks: The European Banking Union and the Response to Covid-19' (2021) 32 European Business Law Review 437; and Claudio Borio and Fernando Restoy, 'Reflections on regulatory responses to the COVID-19 pandemic' (April 2020) FSI Briefs No 1, bis.org/fsi/fsibriefs1.pdf.

temporarily any distributions to shareholders or recommended careful attention in doing so.

After a first phase where most supervisory authorities took a rather strict stance, the limitations have progressively been relaxed. Thus, banks have been allowed, in a second phase, to make distributions to their shareholders within certain limits calculated on economic results or basis points of the capital requirement.

As the deadline for the extension of the various limitations approaches, also in view of the stabilisation of the economic forecasts following the pandemic, a debate is underway as to whether such restrictions on shareholders' distributions should be maintained, revised or repealed.

Given also the specific mandate given to EU Commission on this topic by Regulation (EU) 2020/873 (so called 'CRR quick-fix'),[4] restrictions on shareholders' distributions emerged in the context of the COVID-19 crisis, despite being the result of exceptional circumstances, deserve specific analysis.

In fact, the decision to curb banks' dividends and share buy-backs in order to pursue a public interest has given rise to a number of questions, among which we think three should be considered closely.

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[4] See Article 518 *b*) CRR - *Report on overshootings and supervisory powers to limit distributions*, enacted by Article 1 CRR-quick fix, which states that '*By 31 December 202, the Commission shall report to the European Parliament and to the Council on whether exceptional circumstances that trigger serious economic disturbance in the orderly functioning and integrity of financial markets justify: […] b) during such periods, granting additional binding powers to competent authorities to impose restrictions on distributions by institutions. The Commission shall consider further measures, if appropriate'*.

First of all, as to the role of shareholders' interests in banking companies: while opinions are diverging, also in light of the current debate on corporate purpose, as to how to balance shareholders and stakeholders' interests in managing companies in general, and banks in particular, shareholders expectation to get a return on their investment in the company's capital through dividends distributions and share buy-backs cannot be overlooked.

Furthermore, with specific regard to the measures adopted at the European level, it is worth noting that the COVID-19 crisis is the first economic crisis after the enactment of the Banking Union, the first relevant test for assessing its effectiveness in particular in the Eurozone.[5] In this respect, the paper aims to offer some comments regarding the scope and limits of ECB policy interventions in the area of banks' dividends, highlighting the different approach behind the existing supervisory (micro)prudential powers and the recommendation issued during the pandemic.

Finally, it seems worth noting that external public intervention in restricting dividend distributions somehow raises questions as to the effectiveness of bank corporate governance and its role in enabling the board and the management to take decisions that are consistent with all the relevant interests involved in the banking activity.

[5] See Bassani (n 3).

2. Supervisory measures restricting shareholders' distributions for banks: from the first to the second phase

At the outset of COVID-19 supervisory authorities worldwide had been particularly responsive. They generally approved a range of measures recommending suspending both dividends distribution and shares buyback, in view of the overall situation triggered by the pandemic and the concerns about the extent of its impact on the economy.

It is not surprising that regulators and supervisors have outlined the need for banks to pay attention to the urgency of strengthening their capital position when taking decisions, also through refraining from remunerating shareholders by means of capital distributions. What is more striking that such supervisory measures not just relied on the need to ensure the stability of institutions but rather, somewhat innovatively, referred to a broader understanding of the role banks should ultimately play in the economy and, more generally, in wider society.[6]

At the European level, following the EBA's Statement of 12 March 2020 recalling the need to follow prudent dividend and other distribution policies, most prudential supervisory authorities had disclosed general outlooks and engaged in bilateral dialogues with a view to either limiting or suspending dividends distribution or share buybacks. Such measures had

[6] For an overall overview of the supervisory initiatives imposing restrictions on banks' capital distributions in response to the Covid-19 pandemic, See Jean-Philippe Svoronos & Rastko Vrbaski, 'Bank dividends in Covid-19 times' (May 2020) FSI Briefs, bis.org/fsi/fsibriefs6.htm.

been further supported by the subsequent EBA Statement of 31 March 2020.

Yet, in this context, the ECB Recommendation issued on 27 March 2020 (i.e., ECB/2020/19), stemming from the same banking industry request,[7] played a pivotal role. The ECB recommended that each bank under its direct supervision within the SSM shall suspend any dividends distribution and shares buyback at least until October 2020, while also requesting the NCAs to adopt similar measures for less significant banks. Such a novel approach stood out very clearly from the already mentioned ECB Recommendation, adopted pursuant to Article 4(3) of the SSM Regulation, namely with respect to the ECB Recommendation issued in January 2020 (i.e., ECB/2020/01, which substantially replicated the one adopted in January 2019).

In its previous Recommendation, the ECB urged every bank to assess very prudently whether to distribute to the shareholders and, after grouping banks in different categories on the basis of the outcome of the capital adequacy assessment, intensified its recommendations urging the most exposed banks to fully retain earnings to increase their loss-absorbing ability. In the Recommendation of 27 March 2020, the request to refrain from capital distributions until October 2020, addressed to every bank, did not mention the need to further enhance capital requirements to face the significant losses resulting from the COVID-19 emergency. By contrast, it referred to the ability of banks to finance the real economy and the need for banks to finance both households and businesses in the downturn that will certainly follow the pandemic. In other words, the

[7] See EBF, 'EBF letter to ECB/SSM in context of actions to fight Covid-19 pandemic' (Holding Statement, 27 March 2020), ebf.eu/ebf-media-centre/ebf-letter-to-ecb-ssm-in-context-of-actions-to-fight-covid-19-pandemic.

authorities' pressure to suspend any shareholders distribution was not mainly driven by enhancing banks resilience, but rather by prompting banks to allocate as much resources as possible to lending activities, in order to ensure them to keep on performing during the economic crisis their core intermediation function.[8]

In this respect, the reason for the ECB/2020/19 Recommendation not to treat banks differently on the basis of their capital position and require all of them to suspend any distribution of equity to shareholders is crystal clear. In fact, considering that the less solid banks had already been requested to refrain from distributing dividends, the recommendation to retain all the earnings to be then employed to support the economy and the society in a downturn was actually addressed to the soundest institutions.

The UK Prudential Regulation Authority also referred to the peculiar function that, particularly during a crisis, banks are expected to perform in supporting the whole economy and society at large. In fact, after having informally urged the largest UK banks not to distribute dividends, on 31 March 2020, the UK body published a statement where it publicly welcomed the choice to suspend dividends distribution and shares buy-back until the end of 2020.

After the ECB/2020/19 Recommendation, also the European Systemic Risk Board (ESRB) acting from a macro-prudential perspective issued at the end of May a Recommendation to all the EU Competent Authorities in all the financial sectors to

[8] The same approach was clarified by Andrea Enria, Chair of the Supervisory Board of the ECB, in his Public hearing at the European Parliament's Economic and Monetary Affairs Committee on 5 May 2020, wherein he said how vital in such a phase is to retain as much capital as possible within the banking sector to support the real economy.

‘request financial institutions under their supervisory remit to refrain from making distributions or buying back shares whose effect was to reduce the quantity or quality of own funds (...) until, at least, 1 January 2021’. With particular reference to the banking sector, also the ESRB highlighted that banks ‘play a critical function in the economy’ and that restrictions in capital distribution aims ‘to increase their resilience during the crisis and promote necessary lending to the banking sector’.

Following the ESRB Recommendation, the ECB extended its distribution restriction Recommendation until the end of 2020 with a new Recommendation of the 27 July 2020 (i.e., ECB/2020/35).

Also, the European Commission intervened in this regard with the Commission Interpretative Communication on the application of the accounting and prudential frameworks to facilitate EU bank lending (Supporting businesses and households amid COVID-19) on 28 April 2020. The Communication confirmed several statements in the banking sector made by the Basel Committee of Banking Supervision, the European Banking Authority (EBA) and the European Central Bank. Importantly, it also highlighted those areas where banks are encouraged to perform responsibly (including by refraining from distributing dividend to shareholders or adopting a conservative approach to the payment of variable remuneration).

As time has passed since the onset of the pandemic and a somewhat more accurate situation has unfolded with respect to its impact on the economic system, the approach of the supervisory authorities regarding the distribution of dividends began to change. As a result, there certainly seems to be a coordinated effort by major central banks to ease at least some of the former dividend rules.

In this perspective, on 15 December 2020, the ECB issued a new recommendation on dividends distribution restrictions (i.e., ECB/2020/62), reporting from 1 January 2021 the possibility of limited distributions up to 15% of the accrued profits for financial years 2019 and 2020 or 20 basis points in terms of CET1 ratio of the credit institution, whichever is lower. Therefore, a double limit related to the number of profits from the previous two financial years and no more than 20 basis points of the highest quality available capital resources. Anyway, the Recommendation still takes an overwhelmingly prudent approach, recommending banks deciding to carry out distributions to contact the relevant Joint Supervisory Team to discuss whether the planned distribution is prudent.[9]

In providing supervisory forward guidance to credit institutions, the ECB also clarified that 'in the absence of materially adverse developments' the Recommendation will be repealed on 30 September 2021 and the issue of distributions will again be assessed on a case-by-case basis within the standard supervisory cycle.

In this second phase, the Bank of England (BoE) alike, after a series of stress tests, softened its approach to dividends, thus allowing, with the Statement of 10 December 2020, the distribution of capital with some limitations in any case less stringent than those set by the ECB. More specifically, banks have been asked to limit their dividend pay-outs: i.e., either to the highest of 25% of profits generated for both 2019 and 2020 excluding previous dividend payments or 0.2% of the value of

[9] See Bassani (n 3).

their riskiest assets. ‘Notwithstanding the impact of the COVID-19 pandemic on the global economy, banks remain well-capitalised and are expected to be able to continue to support the real economy through this period of disruption,’ stated the BoE’s Prudential Regulation Authority (PRA).[10]

To conclude this brief survey of the supervisory measures taken at global level, it is necessary to take a look at the strategy adopted, on the other side of the Atlantic, by the FED. After an initial period where, in spite of the voluntary decision taken by the major banks to suspend share buyback programs, the FED had not intervened in order to limit or discourage the dividends distribution, on the heels of stress tests conducted in June 2020 that found out banks risked up to $700bn in losses due to the pandemic,[11] the FED, after a thorough assessment of such results,[12] has also taken a stance on the issue of dividend distribution. More precisely, the FED has since forbidden big US banks (33 banks with more than $100bn in assets) from buying back shares and capped their dividends (restrictions extended in September 2020 until the end of the year), as it wanted banks to maintain a ‘high level of capital resilience’ against the backdrop of ‘continued economic uncertainty from the coronavirus response’. The cap means dividends can be no

[10] Bank of England, ‘PRA statement on capital distributions by large UK banks’ (Press release, 10 December 2020), bankofengland.co.uk/prudential-regulation/publication/2020/pra-statement-on-capital-distribution-by-large-uk-banks.
[11] Federal Reserve Board, *Dodd-Frank Act Stress Test 2020: Supervisory Stress Test Results* (25 June 2020), federalreserve.gov/publications/files/2020-dfast-results-20200625.pdf.
[12] Federal Reserve Board, *Assessment of Bank Capital during the Recent Coronavirus Event* (25 June 2020), federalreserve.gov/publications/files/2020-sensitivity-analysis-20200625.pdf.

higher than either the previous year payout or the average earnings for the previous four quarters.

The Federal Reserve extended its restrictions through 2021 first quarter and then until 30 June 2021; however, it also eased the cap first placed on dividends in June 2020. The first quarter will also be the first where dividends and share buybacks will be based upon income earned in the prior four quarters, and this should promote an easing of restrictions as conditions improve.

3. Approaching the third phase

In view of the approaching deadline of 30 September 2021 specified in ECB/2020/62 Recommendation (and, more generally, with regard to the entire banking and financial intermediation sector, in ERSB/2020/15 Recommendation) for the review of the limitations on shareholders' distributions, the debate has been rekindled at European level on whether or not to continue to provide for some form of restriction at Supervisory Authority level. The debate is similar to the one sparked off at the end of 2020 when the recommendation requiring banks to refrain from making any form of distribution expired.

Undoubtedly, there are diverging opinions on the level of precaution to be taken in removing the measures adopted to deal with the pandemic emergency. These different approaches are above all connected to the different reliability given to the forecasts of the economic outlook, which though having been progressively refined and settled, must necessarily still deal with a range of uncertainty. Nevertheless, and beyond those, there tends to be a prevailing idea that the measures aimed at limiting the general distribution of resources to shareholders by banks must be overcome.

Indeed, the recommendation not to proceed with any distribution, as well as the recommendation adopted in the second phase, aimed at restricting the banks' discretionary margins in recognizing remuneration to their shareholders, is considered to be an extraordinary measure. As such, therefore, it could only be justified in exceptional circumstances and, in any case, on a provisional basis. The situation is widely expected to return to how it was before the pandemic, characterised by the presence of an ECB recommendation aimed at limiting distributions to shareholders in a diversified manner, only to banks with capitalisation ratios that, although in line with the prudential requirements, are considered appropriate to be further increased (see ECB/2020/01).

Nevertheless, it is worth noting that recent international publications have highlighted the positive effects generated by the restrictive choices adopted by the banking supervisory authorities in terms of distributions to shareholders. In particular, widespread support is given to the idea that such a choice has greatly increased the resiliency of the banking sector and allowed it to carry out the fundamental task of supporting the economy by granting new financing to companies to deal with the emergency situation.[13]

In the same direction, it is frequently pointed out that banks are exposed - especially when market capitalization resulting from the listing value is lower than the asset value - to distribution

[13] See Bryan Hardy, 'Covid-19 bank payout restrictions: effects and trade-offs' (10 March 2021) BIS Bulletin n. 38, bis.org/publ/bisbull38.pdf; David Martinez-Miera and Raquel Vegas, 'Impact of the dividend distribution restriction on the flow of credit to non-financial corporations in Spain' (2021) Analytical Articles Economic Bulletin Banco de España, papers.ssrn.com/sol3/papers.cfm?abstract_id=38215652021; and also Svoronos and Vbraski (n 6).

incentives in favour of shareholders that produce sub-optimal results, as also shown by the 2008 financial crisis.[14]

Such reports imply that the possibility of wider recourse to restrictions on distributions favouring shareholders in the banking sector should not be ruled out, thus raising doubts about whether it would be appropriate to exclude an extension of the powers attributed to supervisory authorities in this direction.[15]

Therefore, further analysis is required, also in view of the experience gathered in the pandemic, as to the nature and function of provisions which introduce, both at regulatory and supervisory level, external limits to the possibility of making distributions to shareholders, in addition to those that can be inferred from the general rules of company law.

4. The rationale for remunerating equity capital raised for the banking business

The baseline for any further analysis is that insofar as the banking business is carried on through the joint stock company model, which is, as such, characterised by a profit-making purpose, the regulatory limitation on the distribution of resources in favour of the shareholders can only be exceptional.

[14] Leonardo Gambacorta et al., 'Low price-to-book ratios and bank dividend payout policies' (December 2020) BIS Working Paper n. 907, bis.org/publ/work907.pdf.

[15] In a similar vein, even before the pandemic, see Manuel Muñoz, 'Rethinking capital regulation: the case for a dividend prudential target' (2019) ERSB Working Paper Series, esrb.europa.eu/pub/pdf/wp/esrb.wp97~89418c1aa5.en.pdf?cb38df482174a8dac8b28cb4d9b1d558; the paper was the republished, in a slightly amended version, in July 2020 as ECB Working Paper Series, ecb.europa.eu/pub/pdf/scpwps/ecb.wp2433~5f1d71d925.en.pdf.

The collection of capital among private individuals achieved by issuing equity instruments is based on the acknowledgement of the interest in remuneration for those who decide to contribute such resources. Indeed, in an economic market system, where the allocation of financial resources is entrusted to competitive mechanisms, the comparison between the expectations of remuneration of invested capital is a fundamental element of investment choices, both in relation to the various economic segments and in relation to companies operating within the same segment.

To the extent that banking activity is carried out through shareholding companies with a profit-making purpose, the need to remunerate equity capital is an essential feature both from a legal and economic perspective. Therefore, the possibility for banks to distribute dividends in favour of those who contribute risk capital resources in a manner competing over companies operating in other economic sectors represents the reference point for any further debate. This assessment would be different whenever the forms to be used to carry out the banking activity were fundamentally redefined. For instance, by favouring recourse to legal structures in which the collection of funds by way of risk capital does not take place according to the logic of investment and, as a result, does not imply a remuneration of the same (i.e., public entities, cooperatives, non-profit entities).

Until then, there can be no room for the regulatory provision of a general statutory limitation on the distribution of resources to shareholders, nor for the allocation to the supervisory authorities of a wide discretionary power in this respect. The Chairman of the Supervisory Board of the ECB has also commented in this regard, pointing out that granting the supervisory authorities a binding power to prevent the distribution of dividends 'might negatively affect the long-term sustainability of institutions and markets', 'considering the importance of distributions in enabling financial institutions to raise capital externally'.[16]

Basically, given the availability of own resources - and the possibility of raising them again in the future - is crucial for carrying out any business activity and, in an even more penetrating manner given the specific prudential constraints, for carrying out banking activities, to the extent that the organisational model chosen for raising such resources is represented by profit-making shareholding companies, the possibility of distributing assets to shareholders is an unquestionable feature.

Of course, this should not be taken to mean that the option to make distributions to shareholders is free from restrictions and limitations.

As widely regarded, this issue is of utmost importance in the context of general company law. Traditionally, it refers to the need to harmonise the different claims on the available assets and, in particular, the interest of shareholders in obtaining a remuneration during the corporate activity with the interest of creditors in not being jeopardised the possibility of satisfying their claims through an undue reduction of the asset guarantee. More recently, the advisability of favouring, in the performance of business activities, management models aimed at achieving the greatest possible increase in assets so as to maximise the

[16] Andrea Enria, 'Letter from Andrea Enria, Chair of the Supervisory Board, to Mr Giegold and Mr Urtasun, MEPs on on the appropriateness of supervisory powers related to dividends and share buy-backs' (18 May 2021), bankingsupervision.europa.eu/ecb/pub/pdf/ssm.mepletter210519_Giegold_and_Urtasun~0bcf15ad50.en.pdf.

possibility for shareholders to obtain remuneration for the funds provided has been questioned in favour of more inclusive models. Under the latter, profits are achieved alongside the pursuit of other and further interests, including general or collective ones, also in view of the interest of stakeholders in this regard.

5. The common rationale for restricting the remuneration of capital raised for the banking business

The overall views on corporate purpose and, more specifically, the role to be acknowledged in shareholders' remuneration also apply to banking companies. Indeed, to some extent these concepts apply all the more so to the banking business, where, mainly after the 2008 financial crisis, there is a widespread assumption that management must be oriented towards the balancing of a wide range of interests and must take into account the special collective concern for the correct performance of the banking business.

Actually, the special and unique features of the banking business are behind a regulatory framework giving priority to capital requirements, which inevitably affects the rules governing the distribution of equity to shareholders.

From a regulatory perspective, the evidence comes from at least three different aspects:

- first and foremost, the capital requirements set by the prudential regulations, in setting a maximum level of exposure to risk in the performance of activities due to the endowment of own resources, indirectly result, given the exposure to risk, not only in making a certain portion of capital unavailable but also in preventing the distribution of any profits eventually gained (in the face, for example, of an increase in the risk the assets are exposed to or an increase in the capital requirement deriving from regulatory or supervisory provisions);

- secondly, it is worth remembering that even when the minimum capital requirements are met, if the capital is not sufficient to ensure compliance with the additional capital requirement represented by the capital conservation buffer, the bank faces a regulatory limitation on capital distributions to shareholders and, specifically, on the economic result achieved;

- thirdly, the regulations relating to provisions for prudential purpose affect the resources available for distribution to shareholders: not by chance, moreover, nearly at the same time as the adoption of the second ECB recommendation on the subject of limits to the distribution of dividends, the same supervisory authority - almost to supplement the same - deemed it necessary to address a communication to the market urging all banks to properly identify and report asset quality deterioration in order to set appropriate provisions for prudential purposes (SSM-2020-0744);

It should also be pointed out that the powers of the supervisory authorities with regard to prudential capital requirements end up affecting, to a more or less direct extent, the opportunity for the bank to remunerate its shareholders. Three approaches can be identified here as well:

- firstly, as part of the supervisory powers, the authorities can directly impose a limit on the distribution of capital to the shareholders of a given bank (cf. Regulation (EU) 1024/2013, Article 16, paragraph 2 h);

- secondly, the setting of an additional capital requirement, which the supervisory authority can set as part of the SREP assessment (cf. Regulation (EU) 1024/2013, Article 16, paragraph 2, letter a), results in the unavailability of an additional portion of capital (for the same level of risk assumed) and, moreover, in a corresponding increase in the level of capital required to meet the capital conservation buffer (with consequent subjection, in the event of non-compliance with the latter, to the limits on capital distributions envisaged by the regulations);

- Thirdly, the other powers to affect the degree of availability of capital should not be overlooked and, in particular, that of imposing a specific provisioning policy (Regulation (EU) 1024/2013 Article 16, paragraph 2d).

Furthermore, there is the general power to make recommendations (i.e., Regulation (EU) 1024/2013, Article 4, paragraph 3), which until before the pandemic was exercised with regard to distributions of capital to shareholders, although in a diversified manner, making a distinction between different categories of banks on the basis of the relevant degree of capital soundness (i.e., ECB/2020/01).

In any case, these powers should be implemented on the basis of specific situations and are linked to the supervision of compliance with the capital requirements set for banking activities.

Both at the regulatory and supervisory level, the specific framework banks are subject to thereby entails a range of further significant limits to the possibility of remunerating shareholders. However, it is worth pointing out that such limits are the outcome of the specific framework designed to protect the special public interest in the sound and prudent performance of the banking activity.

Limits to the remuneration of shareholders to be envisaged in the general banking regulations, therefore, directly result from the prudential regulations, so much so that, to the extent this prudential requirement is properly complied with, the possibility of granting remuneration to shareholders has no other limits or constraints than those generally applying to all companies.

6. The pandemic and the broadening of the rationale for restring remuneration of capital: insights

When experiencing outstanding events such as the pandemic, in the financial sector and, still further, in the banking one, the need has arisen to intervene on capital distributions according to a different approach, not inspired by micro-prudential principles, but rather by macro-prudential approaches.

Not by chance, in this respect, did the ECB recommendations end up overlapping, in terms of content, with those of the ESRB.

The pandemic has shown a twofold and somewhat opposing need: on the one hand, to ensure and, to some extent, increase bank financing as a support to the economy in a moment of deep crisis and, on the other, to make sure that the likely consequences of the pandemic on the profitability of companies and their ability to repay their debts are properly assessed and accounted for from a prudential perspective.

The ECB, thus, took action by adopting various relief measures (capital, liquidity, and operational relief) to free up additional capital.[17] At the same time, in view of the exceptional crisis situation, the ECB urged banks to adequately assess, classify and measure (credit) risk on their balance sheets in light of the extreme economic crisis caused by the pandemic (i.e., SSM-2020-0744). Though, while ensuring banks avoid a reduction in capital requirements due to the increased risk caused by the pandemic, the joint effect of such measures may fall short of the macroeconomic need to provide financial support to the economy. This primarly because granting new loans, especially during a crisis, increases the risk exposure and, consequently, it lowers the capital ratios of a bank.

In the framework of prudential regulations, the provision of additional buffers, and in particular, the Counter Cyclical Buffer (CCyB)[18] and the Capital Conservation Buffer (CCB)[19], theoretically served the purpose of providing banks with leeway in such cases, so much so that the ECB has expressly clarified that exceeding such buffers in a pandemic event should not indicate a state of crisis. However, banks have been unwilling to make use of such a margin in carrying out their activities and instead preferred not to fall below the capital requirement set by

[17] See Bassani (n 3).
[18] As defined by Article 130 of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, OJ L 176.
[19] As defined by Article 129 of Directive 2013/36/EU.

the CCB so as to avoid being subject to the regulatory limits on distributions applicable in this case (i.e., Article 140 Directive 2013/36/EU). Basically, managers and, in broader terms, governance boards refused to allow their decision-making process to entail the application of regulatory limits to dividend distribution (and variable remuneration).

In such a situation, within the EU and in many other jurisdictions alike, supervisory authorities took an unprecedented decision, beyond the remit of (micro-)prudential scope of their powers and requested all banks to suspend or limit shareholders distributions in order to increase the financing to the economy. By recommending the retention of any positive economic results from the previous financial year to be allocated to reserves and not distributed to shareholders, the supervisory authorities intended to boost the overall amount of bank capital and, accordingly, with equal capital requirements, their ability to take risks.

The attitude adopted by the authorities on capital distributions to shareholders in the pandemic situation and, in particular, on dividend distributions prompts two sets of remarks.

The first is whether the supervisory authorities should be granted a general and binding power to prevent distributions to shareholders, at least under exceptional circumstances.

The issue has recently been addressed to the Chairman of the Supervisory Board of the ECB, who has opposed it, mainly due to the concern that this would adversely affect the ability of banks to raise capital in the future.

Such a position recalls the comments made earlier with regard to the choice of entrusting the performance of banking activities to legal entities in the form of joint-stock companies and, as a result, to the methods chosen for raising equity capital. The profit-making shareholding company is considered the most suitable legal structure for banking activities since it allows to carry out operations of capital strengthening in the presence of a difficult situation. However, it should be noted that those who participate in such capital increases do so in view of a remuneration in line with the results of the activity for the funds provided. It may be argued that, especially in the light of the most recent developments with regard to corporate purpose, shareholders' remuneration no longer can be considered the sole or even the primary objective of the corporation, but it still does identify an essential element of such legal structure.

To be sure, in so far as banking companies are concerned, within the EU, supervisory authorities have already the power to prevent the distribution of dividends to shareholders. However, such power may be used only in those cases where banks show a capital shortfall or are at risk of falling below the capital requirements, thus in order to protect banks' stability. To note, in all these cases, while protecting the stability of a bank (and, indirectly, of the system), the supervisory authorities also protect shareholders and their expectation of a return on their investment, at least in the medium-long term.

The case of intervention by the supervisory authorities in times of pandemic shows a different approach, largely beyond the perspective of (micro-)prudential supervision. The choice of formally resorting to the instrument of the non-binding recommendation is a clear hint in this direction. In such a case, the recommendation not to distribute dividends is only partially functional to ensure the stability of the individual bank and is linked, as already mentioned, more to the macro-prudential need to ensure financial support for the economy.

The latter point of view highlights the need to reconsider, in the context of the European architecture, the ways and means by which we intend to respond to needs of a macroeconomic nature, both in terms of the role that authorities called upon to carry out (micro-)prudential supervision tasks can play, and, furthermore, to what extent independent (technical) authorities should be entrusted the power to make macroeconomic decisions.

On the second consideration, it would be interesting to understand why the boards of the banks, faced with the seriousness of the situation that had arisen and the full convergence of the evaluations regarding the need to provide financial support to the economy, were not able to take an independent stance on the inappropriateness, given the situation, of distributing dividends[20] to shareholders and preferred to ask the supervisory authorities to provide external support to such choice.

In this regard, it has been pointed out that the intervention of the supervisory authorities has had the function of preventing the individual choice of a bank not to distribute dividends from being perceived as evidence of a difficult situation for the latter (so-called 'signalling effect'). It does not seem, however, that the scope of this argument can be overestimated, all the more so if the justification at the basis of the decision not to distribute capital, given the exceptional nature of the circumstances, had

[20] In this context, special importance does not seem to be given to the fact that in some legal systems, the recommendation of the Board of Directors concerning the distribution of dividends is binding, while in others, the decision on the matter falls within the responsibility of the Shareholders' Meeting and, with it, the possibility of departing from the indications of the Board of Directors, given that, beforehand, no Board of Directors has decided to express an independent opinion against the distribution of dividends.

been traced back to the desire to ensure the highest degree of resilience for the bank and its ability to grant financial support to the real economy.

Rather, the solicitation addressed by banks directors to the supervisory authorities seems to be due to the will (also in view of the risk of being confronted with different choices made by other banks) not to take on the responsibility for a decision that could potentially leave unsatisfied the shareholders, who still have the power to appoint and revoke directors, If that is the case, there seems to be the need to focus on the effectiveness of the boards of banks and on the appropriateness of bank corporate governance rules, and whose primary objective has been deemed to be, especially after the 2008 Financial Crisis, in light of 'the crucial role that bank play in the economy', that of 'safeguarding stakeholders' interest in conformity with public interest on a sustainable basis'[21], and even more so given the recent developments in the general debate on corporate governance related to sustainability.

7. Conclusions

As part of the efforts to reduce the negative economic effects of the pandemic, the financial sector supervisory authorities took steps to reduce distributions to bank shareholders. Such measures have been implemented in the European Union via recommendations issued by the ECB urging all banks not to distribute dividends and then to retain any distributions within predefined limits.

[21] BCBS, *Guidelines – Corporate governance principles for banks* (July 2015), bis.org/bcbs/publ/d328.pdf.

At the heart of such measures is the need to strengthen the capital base of banks so as to make them better qualified to offer the maximum possible financial support to the economy during the pandemic crisis.

Although justified by special circumstances, such measures call for some debate on the opportunity to apply general dividend distribution limits to banks, both in terms of regulation and supervision.

It is essential to take into account, on the one hand, the general provisions related to shareholders' rights and the role attributed to the remuneration of capital in the context of company law. On the other, the prudential provisions applicable to banks, which already envisage the application of restrictions on distributions to shareholders when necessary to protect the capital soundness of each bank.

The profitability of the funds raised as equity through the issue of shares is an essential feature of joint-stock companies, and any divergences from such a principle must be duly grounded. The limitation insofar provided for in the context of bank regulation is linked to the need of ensuring compliance with the capital adequacy requirements set by the regulations governing the public authorities.

The measures taken during the pandemic stand on a different level and meet a macro-prudential, if not economic policy, approach, inspired by the need to protect the collective interest in ensuring banks provide sufficient financial support to the economy so as to avert a collapse of the entire economic system.

When delving into whether or not to formalise such measures and frame them in further details, three aspects must be carefully considered. First, the relationship between shareholders distribution and the raising of capital in the context of joint-stock companies. Second, the difference between prudential supervision and blanket dividend restrictions, also as to the allocation of powers in the overall supervisory framework among different authorities or bodies. In addition, the question of the extent to which the banks' internal governance discipline and the effective capacity of the corporate boards to take independent decisions seemingly unpopular with the shareholders, yet suitably justified by the need to protect different and additional interests connected to the performance of the banking activity, should be addressed.

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13. Cultural reforms in Irish banks – A pandemic report card

Blanaid Clarke

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1. Introduction

In June 2020, the author completed a chapter for the first edition of this E-book entitled 'Cultural Reforms in Irish Banks – Maintaining Cultural Progress in the wake of the COVID-19 Pandemic'.[1] It considered the cultural reforms introduced in response to the previous global shock to hit the Irish banking sector,[2] the Global Financial Crisis in 2008 ('the GFC'), and explored the extent to which they influenced the sector's response to the economic crisis precipitated by the COVID-19 Pandemic ('the Pandemic'). Unlike the GFC, the Pandemic offered banks an opportunity to be part of the solution rather

[1] Blanaid Clarke, 'Cultural Reforms in Irish Banks – Maintaining Cultural Progress in the wake of the Covid-19 Pandemic' in Christos V Gortsos and Wolf-Georg Ringe (eds), *Pandemic Crisis and Financial Stability* (EBI 2020) 127-155, ssrn.com/abstract=3607930.

[2] The term "banks" is used in this chapter to refer to all credit institutions including banks and building societies.

than part of the problem. Focusing on the five Irish retail banks, the chapter provided evidence that there had been a marked improvement in the response of the banks to the Pandemic in the first half of 2020. While it was not possible to prove a causal link, the banks' actions were consistent with their commitments to improved corporate culture and customer focus. All five banks demonstrated an appreciation of their social licences. This chapter revisits and updates the earlier chapter to examine what the banks did next and in particular, whether they continue along an upward cultural trajectory.

Part II of the chapter will offer a brief examination of the macro-environment in which the banks are operating and the particular challenges which will test their cultural resilience. Part III will consider the sources of bank culture and the importance of defining, establishing, and embedding an appropriate culture and value system within banks. It will also explore the link between culture and accountability in the context of the proposed new senior executive accountability regime in Ireland. Part IV explores the current debate on the purpose of banks in Ireland and their responsibilities to their stakeholders in the context of the wider stakeholder debate taking place in corporate law. Part V will then examine the role played by the Irish Banking Culture Board in influencing culture in the banking sector and ensuring that the Irish banks continue to meet their responsibilities to act in a fair, ethical, accountable, and humane manner.

2. Banking sector overview

The last 12 months have been extraordinary by any measure. Ireland is an open economy and at the time of writing the previous chapter, it was predicted that the economic costs of the

Pandemic would be more significant than those associated with the GFC. The Central Bank of Ireland (CBI) estimated at that time that Irish real GDP could decline by 8% in 2020 with unemployment reaching a peak of 25% in the second quarter of 2020.[3] In fact, Ireland was only one of two EU countries (along with Luxembourg) to experience a growth in GDP in 2020. GDP grew 3.4% fuelled by strong export growth in pharmaceuticals and continued strength in the information technology sector.[4] Unfortunately, the unemployment forecasts proved more accurate and the COVID-adjusted unemployment rate in January 2021 was 25.1%.[5] The economic cost of the Pandemic has been enormous, and Ireland moved from a surplus of €1.9bn (0.9% of GNI[6]) in 2019 to a deficit of almost €20bn (just under 9% of GNI) in 2020. In addition to the Pandemic, although a no-deal WTO Brexit was narrowly avoided, there have been costs associated with Brexit which are already having a negative effect on trade.[7] While economic growth is expected to rebound in 2021 from the 2020 base, with

[3] Central Bank of Ireland, *Quarterly Bulletin No.2 of 2020* centralbank.ie/publication/quarterly-bulletins/quarterly-bulletin-q2-2020.

[4] In a fascinating paper, Patrick Honohan, former Governor of the CBI, explains that while Ireland is a prosperous country, this focus on GNP presents an overly positive picture because of "the inappropriate use of misleading, albeit conventional statistics". See Patrick Honohan, 'Is Ireland really the most prosperous country in Europe?' (2021) 1 Central Bank of Ireland Economic Letter.

[5] In April 2021, the figure had decreased to 22.4%. See Central Statistics Office, Monthly Unemployment Statistics, cso.ie/en/statistics/labour market/monthlyunemployment.

[6] Modified Gross National Income.

[7] Central Bank of Ireland, *Quarterly Bulletin No.2 of 2021*, 35, centralbank.ie/docs/default-source/publications/quarterly-bulletins/qb-archive/2021/quarterly-bulletin-q2-2021.pdf ?sfvrsn =6.

GDP forecast to grow by 5.9% in 2021 and 4.7% in 2022, the unemployment rate is forecast to increase in 2021 and 2022.[8]

Even before the Pandemic, credit risk and capital requirements in Ireland were elevated due to our historical loss experience on loans following the GFC and this resulted in higher credit and capital costs for Irish banks. A Report commissioned by the Banking & Payments Federation Ireland ('the Report') on a study of over 600,000 mortgages across the five Irish retail banks revealed that Irish banks are required to hold about three times more capital for the perceived higher risk in their mortgage loans books compared to average capital requirements in Europe.[9] The Report estimates the higher Risk Weighed Asset (RWA) density represents an additional €2.5bn equity requirement for the five Irish banks which clearly has an impact on the cost of lending and mortgages. This is the case despite the fact that in the last four years, Ireland has significantly reduced its non-performing loan ratio and significantly increased the quality of loans underwritten. It attributes this improvement to the changing risk appetite of retail banks and the introduction of the CBI's macro prudential rules which limit mortgage borrowing levels according to loan to value and loan to income thresholds.[10] The Report also

[8] ibid 5.

[9] Kevin McConnell, 'Irish Mortgage RWA Density Analysis Project Report' (January 2021) Banking & Payments Federation Ireland, bpfi.ie/wp-content/uploads/ 2021/02/ Final- BPFI-RWA-Report.pdf.

[10] The effectiveness of the macroprudential rules in strengthening bank and borrower resilience is evidenced by the fact that payment break take-up rates demonstrate that financial distress is lower in respect of loans issued under the measures relative to those originated under looser conditions during the 2000s. See Central Bank of Ireland, *Financial Stability Review 2020:II*, 10, centralbank.ie/docs/default-source/publications/financial-stability-review/financial-stability/financial-stability-review-2020-ii.pdf.

forecasts that that average RWA density may only fall slowly over the next five years even as better-quality mortgages continue to replace older riskier loans.[11]

Focusing on bank customers, although the income of workers in sectors such as travel and tourism were significantly impacted, average disposable incomes were protected because of substantial government income supports. Firms too were protected from more severe financial distress by government support measures as well as, what the CBI acknowledged was 'exceptional levels of creditor forbearance'.[12] That said, SME debt is expected to continue to accumulate. A CBI study in April 2021 on the impact of the Pandemic on the Irish credit market revealed some tightening in credit supply conditions (although less than during the GFC) driven by 'general economy and borrower specific factors as opposed to bank balance sheet constraints'.[13] Although the credit environment was stable in the first quarter of 2021, the CBI cautioned against credit supply risks in the context of a phasing out of government liquidity supports, the re-opening of the economy, the possibility of an unexpected deterioration in credit quality, and 'individual lender decisions leading to a collectively suboptimal outcome'.[14] Credit supply risk also increased following

[11] The Banking & Payments Federation Ireland Report (n 9) 2 argues that a greater weight must attached to 'a) significant improvements in underwriting quality, b) macro prudential robustness of the mortgage system and c) the success of forbearance measures, when calculating the RWA density for bank mortgage books across Europe'.
[12] Central Bank of Ireland (n 7) 5.
[13] Jane Kelly, Rory McElligott, Conor Parle and Martina Sherman, 'Credit Conditions for Irish Households and SMEs' (2021) 5 Central Bank of Ireland Economic Letter Vol 2021 No.5., 2, centralbank.ie/docs/default-source/publications/economic-letters/credit-conditions-irish-households-and-smes-vol-2021-no-5.pdf?sfvrsn=5.
[14] ibid.

announcements by Ulster Bank and KBC, in February and April 2021 respectively, of their departures from the Irish market. The Minister for Finance ('the Minister') has stated that no large international retail banks are considering moving into Ireland in the immediate future and that competition is likely to come from companies providing digital banking services.[15] Evidence from the last quarter of 2020 suggests that while lenders are actively supporting existing customers throughout the pandemic, they are taking a cautious approach to new borrower proposals.[16] The willingness of the banks to grow lending will only become fully evident when a wider pick-up in economic activity occurs. One positive note thus is the significant increase in the number of loan approvals with monthly levels of mortgage approvals, both in terms of the number and value, since September 2020 reported to be higher than in any comparable month since such data was first published in 2011.[17]

Forbearance on the part of the banks and nonbank lenders has been credited with playing an important role in limiting the immediate economic and social fallout from the Pandemic.[18] The banks have declared their commitment to continue to do so and the CBI has committed to supervising lenders to ensure they have 'appropriate strategies, the necessary financial and operational resources, and a suite of appropriate and sustainable

[15] Paschal Donohoe, 'Banking Sector: Statements' (Dáil Éireann debate Vol. 1004 No. 7, 3 March 2021), 7, oireachtas.ie/en/debates/debate/dail/2021-03-03/10.
[16] Kelly et al. (n 13) 9.
[17] Sean Fleming, 'Banking Sector: Statements' (Dáil Éireann debate Vol. 1004 No. 7, 3 March 2021).
[18] Department of Finance, *Draft Stability Programme Update 2021* (April 2021), 4, gov.ie/en/publication/ac129-draft-stability-programme-update-2021.

solutions to resolve distressed debt'.[19] It has urged lenders to engage sympathetically and positively with distressed borrowers to avoid a build-up of arrears. One must be realistic however and the Government has acknowledged that a rise in the insolvency rate and subsequent rise in non-performing loans will hinder the capacity of the financial sector to finance the transition to the 'new normal'.[20] It is in these times that the cultural mettle of the banks will be tested.

3. Bank culture and management accountability

An important feature in restoring trust in the banks and their leaders is signalling trustworthiness and one of the mechanisms for doing this is developing and communicating a strong ethical culture.[21] There is evidence that a positive corporate culture leads to numerous benefits including: increased profitability; improved employee engagement and productivity; reduced employee dissatisfaction, absenteeism and turnover; improved risk management and mitigation; a greater ability to focus on longer-term goals over short-term pressures; improved customer satisfaction; and improved reputation.[22] Research also

[19] Derville Rowland, Director General, Financial Conduct CBI, 'Conduct, culture and trust – priorities for 2021' (Speech, 16 March 2021), centralbank.ie/news/article/speech-derville-rowland-bpfi-membership-forum-16-mar-2021.

[20] Department of Finance (n 18) 4.

[21] Reinhard Bachmann, Nicole Gillespie and Richard Priem, 'Repairing Trust in Organizations and Institutions: Toward a Conceptual Framework' (2015) 36 Organization Studies 1123.

[22] See for example Duc Duy Nguyen, Linh Nguyen, Vathuyoo Sila, 'Does Corporate Culture Affect Bank Risk-Taking? Evidence from Loan-Level Data' (2019) 30 British Journal of Management 106; Karl Lins, Henri Servaes and Ane Tamayo, 'Social capital, trust, and firm performance: The value of corporate social responsibility during the financial crisis' (2017) 72 Journal of Finance 1785; and John Graham and Campbell Harvey, 'The theory and

suggests that once established or being seen to be established, it is difficult to persuade people of change especially if the culture is perceived to be based on ignorance, recklessness and hubris.[23] This is important given the fact the GFC and the subsequent Tracker Mortgage Examination[24] by the CBI provided ample evidence of these three characteristics at play in the Irish banks.

Culture is determined and guided to a large extent by a company's sense of its own purpose and values. It is thus up to each board to identify and communicate its own particular values and a 'one size fits all' approach is not appropriate. That said, a 'good' bank culture has certain recognisable features. These include: integrity; openness; ethics; regulatory compliance and respect; and a focus on reducing the potential for harm. Boards must demonstrate organisational leadership by establishing the company's purpose and defining and articulating its values and strategy.[25] The G30 *Banking Conduct and Culture Report* reminds us that value statements will be used to guide employees navigating the most challenging areas of behaviour – the grey zones in which adherence to conduct and values principles is a matter of judgment and not of clear-

practice of corporate finance: Evidence from the field' (2017) 60 Journal of Financial Economics 187.

[23] Guy Claxton, David Owen and Eugene Sadler-Smith, 'Hubris in leadership: A peril of unbridled intuition?' (2015) 11 Leadership 57.

[24] Central Bank of Ireland, *The Tracker Mortgage Examination Final Report* (July 2019) centralbank.ie/docs/default-source/consumer-hub-library /tracker -issues/update-on-tracker-mortgage-examination---july-2019. pdf? sfvrsn=6.

[25] The Irish High Court in *the Director of Corporate Enforcement v Boner* [2008] IEHC 151, a directors' disqualification case, commented on the collective responsibility of a bank's officers to ensure the bank complies with its legal obligations in all material respects. The Head of Retail was said to possess particular responsibility '*to establish and maintain an appropriate corporate ethos and communicate and entrench its values throughout the company*'.

cut legal requirements.[26] To facilitate this concept of setting the 'tone from within', boards are responsible for both ensuring that the bank's desired values are aligned, embedded and continually reinforced and also for identifying ethical failings and taking decisive and early action. A key part of this is ensuring that there is effective oversight of systems, controls, and incentives.

The CBI has published a *Consumer Protection Code* and already operates a Fitness & Probity Regime ('F&P Regime') as well as an Administrative Sanctions Regime. However, in its *Behaviour and Culture of the Irish Retail Banks* report published in July 2018, it expressed doubt that 'profound cultural change' in the regulated financial services sector would be achievable without regulatory intervention in the form of a strengthened individual accountability framework.[27] This echoed a call from the Financial Stability Board (FSB) three months earlier for the adoption of a toolkit for firms and supervisors to strengthen governance frameworks by improving corporate culture, clarifying individual responsibility and accountability and preventing employees with a history of misconduct from moving within or between firms. In a report *Strengthening Governance Frameworks to Mitigate Misconduct Risk: A Toolkit for Firms and Supervisors,*[28] the FSB described a lack of accountability for misconduct as a key

[26] G30, 'Banking Conduct and Culture: A Permanent Mindset Change' (2018), group30.org/images/uploads/publications/G30_Culture2018_FNL3lo-compressed.pdf.
[27] Central Bank of Ireland, *Behaviour and Culture of the Irish Retail Banks* (2018) 32. centralbank.ie/docs/default-source/publications/corporate-reports/behaviour-and-culture-of-the-irish-retail-banks.pdf?sfvrsn=2.
[28] Financial Stability Board, 'Strengthening Governance Frameworks to Mitigate Misconduct Risk: A Toolkit for Firms and Supervisors' (20 April 2018), fsb.org/wp-content/uploads/P200418.pdf.

cultural driver of such behaviour. The CBI's proposal consists of four elements. The first involves enhancing its F&P Regime in order to increase the responsibilities of banks to proactively assess and certify individuals in senior management functions and to give the CBI additional powers. The second element involves developing a unified enforcement process for all regulatory breaches and removing the current restriction on sanctioning an individual without first proving that (a) there has been a breach by the regulated firm and (b) the individual has participated in this breach. The CBI has correctly argued that this restriction 'runs counter to the principle of individual accountability under which an individual should be accountable for their own actions'.[29] The third element involves the introduction of *Conduct Standards* for all regulated firms and their employees. These Standards have been described by the CBI as 'very much in line with what any well run firms would expect of the people working for it'.[30]A breach of any of the Standards would give rise to a direct enforcement action. The final element of the proposal involves the introduction of a Senior Executive Accountability Regime (SEAR) modelled on the Senior Managers and Certification Regime (SM&CR) in the UK. The latter was introduced upon the recommendation of the UK's Parliamentary Commission on Banking Standards (PCBS) which had been established to conduct a review of professional standards and culture in the UK banking sector in the wake of the LIBOR rate-setting scandal.

It is expected that SEAR, when introduced, will initially apply only to a sub-set of regulated firms including banks. These firms

[29] Central Bank of Ireland (n 27) 38.

[30] Gerry Cross, 'Accountability and sustainability: key themes in financial regulation' (Remarks delivered to ICSA Ireland Conference, 20 May 2019), centralbank.ie/news/article/key-themes-in-financial-regulation-gerry-cross.

will be required to submit a Statement of Responsibilities to the CBI for each individual exercising a Senior Executive Function (SEF) setting out their SEFs and their prescribed responsibilities. The SEFs will include board members, executives reporting directly to the board and heads of critical business areas.[31]One feature yet to be determined and likely to be the subject of consultation is the extent to which non-executive directors (NEDS) are included within its scope. Under the SM&CR, the only NEDS included are the chairs of the board and key board committees including audit and risk. Under SEAR, banks will also be required to maintain Management Responsibilities Maps setting out the firms' governance and management arrangements and the reporting lines. These maps will thus provide a complete picture of the allocation of responsibilities across the entire firm and demonstrate that all the key responsibilities are being looked after by competent persons. Together the two sets of documentation will make it clear to both the individuals themselves and the CBI which responsibilities are tasked to which individuals.

Since the publication of the CBI's proposals, public and political pressure on the Government to introduce legislation for increased accountability has increased. In March 2021, the CBI announced a €4.1 million fine for one of the country's leading stockbroking firms, J&E Davy, for regulatory breaches arising from personal account dealing.[32] The breaches were aggravated

[31] Central Bank of Ireland (n 27) 36.
[32] Central Bank of Ireland, 'Enforcement Action Notice: J&E Davy fined €4,130,000 and reprimanded by the Central Bank of Ireland for regulatory breaches arising from personal account dealing' (Press Release 2 March 2021), centralbank.ie/news/article/press-release-enforcement-action-davy-fi

by a 'lack of candour' and a failure to 'demonstrate accountability' in the firm's initial reporting of the matter to the CBI. In addition, the internal compliance function was 'side-stepped' in a manner redolent of the circumvention of the risk-management function by banks in the run up to the GFC. Despite indications from the CBI that investigations are still ongoing which suggests that actions may be pursued against individual actors, any such action would depend at present on proving the participation link referred to above. The fine reignited the debate about the lack of individual accountability in the financial services sector, and the Minister promised that a bill on the statutory underpinning of the proposed individual accountability framework, originally announced in 2018, would be introduced in July 2021. The CBI expects to publicly consult on its proposals in early 2022.

The implementation of SEAR would be welcome. In terms of enforcement, it will make it easier to identify the individual accountable for an act or omission constituting misconduct as their name will be on the Statement of Responsibility. By removing the participation link and by imposing a statutory duty of responsibility upon senior executives, it will also be easier for the CBI to use its existing powers to sanction individuals. One step before this however, the imposition of personal responsibilities on named individuals is likely to pre-empt misbehaviour and mismanagement. Senior executives will be incentivised to ensure that they fully understand the precise nature of their responsibilities and the behaviour required of them to meet these responsibilities. Andrea Enria, Chair of the Supervisory Board of the European Central Bank (ECB) noted

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ned-4-130-000-and-reprimanded-by-central-bank-of-ireland-for-regulatory-breaches-arising-from-personal-account-dealing-02-march-2021.

that 'Only when a strong risk culture and sound standards of conduct are fundamentally embedded in the behaviour of the business areas will good decisions become the norm.'[33] Organisational leadership will be key to achieving this. Evidence would suggest that although there have been improvements in culture across the Irish retail banks since 2018, there is still a long road ahead. A survey of staff in the retail banks published by the Irish Banking Culture Board (IBCB) in May 2021[34] revealed that while staff reported having a strong experience of purpose, psychological safety, ethics and employee voice, only 61% agreed that their senior leaders set a positive example. More worryingly, experiences of accountability and organisational cohesion were low with only 64% believing that people would be held accountable for their actions, only 56% being aware of the tone from the top and the same percentage trusting their banks' Executive Committees.

A related advantage of SEAR is that in bringing greater clarity to executive responsibilities, it will serve as a supervisory tool for the CBI. The granular detail provided in Responsibility Statements for example will allow the CBI, like its UK counterparts, to conduct 'a more targeted assessment of the fitness and propriety of prospective and incumbent Senior Managers by allowing their competence, knowledge, experience, qualifications, training and, where relevant,

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[33] Andrea Enria, 'Just a few bad apples? The importance of culture and governance for good banking' (Speech at a Conference of the Federation of International Banks, Dublin, 20 June 2019), bankingsupervision.europa.eu/press/speeches/date/2019/html/ssm.sp190620~f9149fe258.en.html.

[34] Irish Banking Culture Board, 'Survey of Bank Culture, Industry Staff Report' (2021), 603101-1952083-raikfcquaxqncofqfm.stackpathdns. com/wp- content /uploads /2021/05/IBCB-eist-2021-report-RS-060521 _Final_ONLINE.pdf.

proposed time commitment to be measured against the responsibilities they have been allocated.'[35] It will also assist the CBI in the annual supervisory reviews of regulated entities, which must include within its scope corporate culture, values and leadership.[36]Finally, it is hoped that SEAR will contribute to the restoration of trust in banks by improving the perception of dependability within an organisation. As will be discussed in Part V below, this must be part of a broader holistic response to managing culture in the banking sector.

4. Corporate Social Responsibility and the purpose of banks

In evaluating how banks have responded to the Pandemic, it is important to consider their role in society, the tools available to allow them to play this role and the challenges they face. My earlier chapter explored the state of the ongoing debate on shareholder primacy and broader stakeholder theories. It compared the apparently different stances taken by Milton Friedman in his essay 'The Social Responsibility of Business is to Increase its Profits'[37] to Larry Fink in his 'Dear CEO' letter in 2018[38] and the Business Roundtable[39] in its now infamous statement in 2019 that companies must protect the interests of

[35] Prudential Regulation Authority, 'Strengthening individual accountability in banking' (February 2020) Supervisory Statement SS28/15, 16.
[36] Article 98(7) of CRD IV (Directive 2013/36/EU).
[37] Milton Friedman, 'The Social Responsibility of Business is to Increase its Profits' (*New York Times*, New York, 13 September 1970, Sunday Magazine) 32.
[38] Larry Fink 'A sense of Purpose' (17 January 2018) Harvard Law School Forum on Corporate Governance, corpgov.law.harvard.edu/2018/01/17/a-sense-of-purpose/.
[39] Business Roundtable, Statement on the Purpose of a Corporate (19 August 2019), businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans.

all their stakeholders. This debate has continued and even grown in intensity in the last twelve months with interventions from the European Commission[40]and European Parliament[41] on sustainable corporate governance which focus on long-term value creation and the alignment of corporate with societal objectives. The basis of the Commission's initiative, a study by EY,[42] has been heavily criticised in the academic community for perceived methodological flaws as well as its assumption that shareholder value creation is a short-term phenomenon.[43] Larry Fink has also published a 2021 'Dear CEO' letter which continues to emphasise the role of stakeholders noting:

> 'Companies ignore stakeholders at their peril – companies that do not earn this trust will find it harder and harder to attract customers and talent, especially as young people increasingly expect companies to reflect their values. The more your company can show its purpose in delivering value to its customers, its employees, and its communities, the better able you will

[40] EC, *Sustainable Corporate Governance Initiative*, ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance_en.

[41] European Parliament, *Resolution of 17 December 2020 on sustainable corporate governance* (2020/2137(INI)), europarl.europa.eu/doceo/document /TA-9-2020-0372_EN.html.

[42] EC and EY 'Study on directors' duties and sustainable corporate governance' (July 2020), op.europa.eu/en/publication-detail/-/publication/e47928a2-d20b-11ea-adf7-01aa75ed71a1/language-en.

[43] See for example European Company Law Experts, 'Feedback on the Sustainable Corporate Governance Initiative Consultation' (September 2020) ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12548-Sustainable-corporate-governance/F555384_en, and the Oxford Business Law Blog's excellent *European Commission Initiative on Directors' Duties and Sustainable Corporate Governance Series*, law.ox.ac.uk/business-law-blog/blog/2020/10/announcing-new-series-european-commission-initiative-directors-duties.

be to compete and deliver long-term, durable profits for shareholders.'[44]

In general, it might be said that there is a wide consensus as to the objective of corporate governance – achieving long term value for a broad range of stakeholders - but disagreement as to how to achieve it. There is also perhaps a degree of understandable cynicism as to the genuineness of the motives of many of those experiencing an epiphany and advocating a move away from shareholder primacy towards enlightened shareholder or enterprise value.

Although the governance of banks has not been the subject of the same level of academic scrutiny as non-banks in this context, Hopt argued that for banks, stakeholder and, more particularly, creditor or debtholder governance has prevailed over shareholder governance.[45] The Basel Committee's *Corporate Governance Principles for Banks*[46] has acknowledged the crucial role banks play by 'intermediating funds from savers and depositors to activities that support enterprise and help drive economic growth'. It describes the primary objective of corporate governance in banks as 'safeguarding stakeholders' interests in conformity with public interest on a sustainable basis'. The CBI has emphasised its expectation that banks 'act in their customers' best interests in

[44] See Larry Fink's 2021 letter to CEOs, blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.
[45] Klaus J Hopt, 'Corporate Governance of Banks and Financial Institutions: Economic Theory, Supervisory Practice, Evidence and Policy' (March 2020) European Corporate Governance Institute - Law Working Paper No. 507/2020, ssrn.com/abstract=3553780.
[46] Basel Committee on Banking Supervision, 'Guidelines – Corporate governance principles for banks' (July 2015) 3, bis.org/bcbs/publ/ d328.pdf.

tandem with fulfilling their prudential obligations'[47] and if conflicts exist, shareholders' interests should be secondary to depositors' interests.[48] This is consistent too with the views of the Irish Courts. In *The Director of Corporate Enforcement v Boner*,[49] the High Court stated that a licensed bank was 'expected to undertake its business in a legal, ethical and professional manner as it occupied a privilege position of trust in being permitted to take customers deposits and manage them on their behalf and in their interest'.

As noted in the earlier chapter, the Irish banks were in a stronger position to weather the Pandemic because of many of the actions taken in the immediate aftermath of the GFC by the CBI and the ECB. It also described how the banks' actions in the early months demonstrated a recognition of its social licence and its commitment to the values they espouse. This included a joint plan by the five retail banks and the Banking & Payments Federation Ireland, their representative body, to support businesses and personal customers impacted by the Pandemic and to 'play [their] part at this critical time'.[50] In what was described by the junior Minister in the Department of Finance as 'an immediate and flexible response' to the Pandemic, these supports included payment breaks, initially for three months but later extended to six months.[51] More than 150,000 payment breaks were sanctioned for household and SME borrowers,

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[47] Central Bank of Ireland (n 27) 20.
[48] Central Bank of Ireland, *Corporate Governance Principles for Banks* (2015) 3.
[49] [2008] IEHC 151.
[50] Banking & Payments Federation Ireland, 'Banks set out joint plan to support businesses and personal customers impacted by the Covid-19 pandemic' (18 March 2020), bpfi.ie/news/banks-set-joint-plan-support-businesses-personal-customers-impacted-covid-19-pandemic.
[51] Fleming (n 17).

including more than 82,000 on mortgages, almost 36,000 for other consumer loans and 32,500 for SME loans.[52] In November 2020, the CBI wrote to the Banks' CEOs setting out its expectation that the interests of borrowers affected by the Pandemic would be appropriately protected in line with the banks' own strategies, its regulatory obligations and CBI expectations. The banks were asked to confirm that they have the appropriate systems, policies, procedures, practices and borrower communications in place to resolve distressed debt.[53] After the system-wide payment breaks ended, it was reported that the vast majority of borrowers were able to resume full loan repayments (including almost 89% of primary home mortgage borrowers) and the CEOs of the main retail banks had confirmed the adoption of a fair and balanced approach to dealing with mortgage customers.[54]

In terms of external stakeholders, in November 2020, the Banking & Payments Federation Ireland endorsed the United Nations Environmental Programme Finance Initiative's *Principles for Responsible Banking.*[55] The 220 banks from over 60 countries who are signatories to these Principles are also reported to have been 'sharing practices, solutions and lessons learned as they respond to the COVID-19 crisis and its

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[52] ibid.

[53] Central Bank of Ireland, *Expectations for lenders in supporting borrowers affected by the COVID-19 Pandemic* (November 2020) centralbank.ie/docs/default-source/consumer-hub-library/covid-19/dear-ceo-letter---expectations-for-lenders-in-supporting-borrowers-affected-by-the-covid-19-pandemic.pdf?sfvrsn=4. This followed an earlier letter sent on 8 June 2020, centralbank.ie/docs/default-source/regulation/industry-market-sectors/covid19/dear-ceo-payment-breaks-expectations.pdf?sfvrsn=4.

[54] Fleming (n 17).

[55] See the UN Enviroment Programme – Finance Initiative website at unepfi.org/banking/bankingprinciples.

economic impacts'.[56] All five retail banks have also achieved the *Business Working Responsibly* mark from Business in the Community Ireland.

At the outset of the Pandemic, a number of countries issued recommendations or restrictions on dividends, share buybacks and remuneration policies for banks, and most of these have remained in place.[57] In March 2020, the ECB asked banks not to pay dividends or perform share-buy-backs at least until October 2020 in order to conserve capital to support the real economy and absorb losses.[58] This date was subsequently extended to 30 September 2021.[59] National competent authorities were expected to apply this recommendation to banks under their prudential supervision and the CBI has requested those that intend to decide on or pay out dividends or perform share buy-backs aimed at remunerating shareholders to engage with it as to whether the level of intended distribution is prudent.[60] In its May 2021 *Financial Stability Report*, the ECB recommended that banks can proceed with capital distributions up to a conservative threshold set by the competent authorities.

[56] UNEP Finance Initiative, 'Covid-19 and Sustainable Recovery' unepfi.org/banking/bankingprinciples/covid-19-and-sustainable-recovery.

[57] FSB, 'COVID-19 support measures – Extending, amending and ending' (April 2021) 36, fsb.org/wp-content/uploads/P060421-2.pdf.

[58] ECB, Recommendation of the European Central Bank of 27 March 2020 on dividend distributions during the COVID-19 pandemic and repealing Recommendation ECB/2020/1 (ECB/2020/19, 2020/C 102 I/01), recital 1.

[59] ECB, Recommendation of the European Central Bank of 15 December 2020 on dividend distributions during the COVID-19 pandemic and repealing Recommendation ECB/2020/35 (ECB/2020/62,2020/C 437/01). See also ESRB, Recommendation of the European Systemic Risk Board of 15 December 2020 amending Recommendation ESRB/2020/7 on restriction of distributions during the COVID-19 pandemic (ESRB/2020/15, 2021/C 27/01).

[60] See COVID-19 – Regulated Firms FAQ at centralbank.ie/consumer-hub/covid-19/faq-for-regulated-firms.

It noted that analysis indicates that while restrictions on distributions increase the resilience of banks by ensuring that capital is used to support the real economy and absorb losses, they may negatively affect bank valuations due to the uncertainty over future distributions. The ECB also recommended that banks adopt a prudent, forward-looking stance in determining remuneration policies. The CBI thus indicated that banks should adopt a prudent approach with regard to variable remuneration payments until 30 September 2021. This applied in particular to staff classified as 'material risk takers'. It stated that less significant institutions should consider 'the extent to which it is possible to limit payments of variable remuneration, and where not possible, to consider whether a larger part of variable remuneration could be deferred for a longer period or paid out by means of instruments'. Insofar as it may negatively affect the amount or quality of total capital, the CBI stated that banks should ensure that amounts distributed (in combination with dividends and share buybacks during the same period) do not exceed the lower of 15 % of the credit institution's accumulated profit for the financial years 2019 and 2020 and 20 basis points in terms of its Common Equity Tier 1 ratio.[61]

The debate surrounding the purpose of banks has intensified in Ireland since the publication of the earlier chapter as a result of the aforementioned announcements by Ulster Bank and KBC (two banks owned by non-Irish parent companies) of their departure from the market and announcements by AIB and Bank of Ireland of branch closures. In the Irish parliament, as one might expect, many politicians adopted a parochial focus criticising the closure of branches in their own constituencies.

[61] See ibid.

There were also renewed calls for the establishment of a stakeholder public bank and the development of community banking.[62] The Financial Services Union (FSU), representing most of the 23,000 bank employees in Ireland, has calling for the Irish and Northern Irish governments to convene a stakeholder forum to discuss the future of banking and whether the banking system is fit to serve the needs of society and the economy. Such a forum, it has suggested, would inform business practice, government policy, legislative and regulatory approaches and raise public awareness. The FSU has identified a number of issues to be discussed in this context including: the lack of public trust in banking; the speed of change in the sector; international and EU banking trends; artificial intelligence; branch closures SME lending; digital risks; financial exclusion, illiteracy, and digital exclusion; and banking culture, ethics and whistleblower protection.[63] The Irish Government declined to participate in the forum making the argument that it would be inappropriate for it to participate in the formulation of proposals in the forum which it would subsequently be called upon to consider objectively.[64] It however noted the willingness of the retail banks and the IBCB to participate in any such debate and indicated its readiness to review any recommendations. It is hoped that an informed conversation on this subject can be facilitated engaging all stakeholders in the shared objective of developing a fit for purpose banking sector to the long-term benefit of customers and banks alike. The Minister has recently stated his intention to establish a review process to examine the

[62] See generally Fleming (n 17).
[63] Financial Services Union, 'The Future of Banking in Ireland and Northern Ireland' (March 2021), fsunion.org/assets/files/pdf/fsu_the_future_of_banking_a5_booklet.pdf.
[64] Fleming (n 17).

issues facing the banking sector and has indicated that this is likely to involve engagement with a wide range of stakeholders ensuring that 'the process is a holistic one' and that 'the future of banking is not determined by incumbents'.[65]

5. Irish Banking Culture Board

The Irish Banking Culture Board (IBCB) is a private sector body which was established in 2019 by the five retail banks in Ireland. Its objective is to rebuild trust in the banking sector through promoting a cultural environment in which 'ethical behaviour lies at the heart of banking, values are restored, and reputation for competence is rediscovered.'[66] The model for the IBCB was the UK's Banking Standards Board (recently renamed the 'Financial Services Culture Board') which was established in 2015 by seven banks in the UK to assist in raising standards of organisational behaviour, competence and culture in the wake of the aforementioned PCBS report. The ICBC's board constitutes five senior individuals from the five Irish banks, eight non-banking directors and an independent Chairman.[67] The non-banking members have a broad range of expertise and stakeholder experience relating to financial services' employees, consumers, SMEs, tracker-mortgage

[65] Paschal Donohoe, Banking Sector: Parliamentary Questions (Dáil Éireann, 15 June 2021) 7, oireachtas.ie/en/debates/question/2021-06-15/77/#pq_77.
[66] John Hedigan, 'Opening Statement at the Oireachtas Finance Committee' (Opening Statement of Mr. Justice John Hedigan, Chair of The Irish Banking Culture Board, at the Oireachtas Finance Committee, 1 October 2019) irishbankingcultureboard.ie/opening-statement-of-mr-justice-john-hedigan-chair-of-the-irish-banking-culture-board-at-the-oireachtas-finance-committee.
[67] For the sake of transparency, the author notes her membership of the IBCB board and she would like to express her gratitude to Marion Kelly, CEO of the IBCB for her comments on section 5 of an earlier draft of this chapter.

customers and farmers. The IBCB is not a representative organisation or a regulatory body but rather it describes itself as ‘an independent voice in banking’ and a ‘critical friend’ to the banks holding them to account through constructive commentary, as well as through measuring and assessing culture in the sector.

On the basis of two extensive surveys of stakeholders and bank employees in 2018, conducted prior to its formal establishment, the IBCB identified nine key priorities: respectful and transparent communications; customers in vulnerable positions; SMEs; bereaved customers; financial education and literacy; support for community and society; speaking up; staff resilience; and ethics and behaviour. In its first year in operation, the IBCB established working groups and engaged with stakeholders in responding to these priorities. This has resulted in a number of tangible steps towards improving banking practices including a commitment of care for recently bereaved customers and customers in a vulnerable position. A workstream focusing on ethics and behaviour produced in September 2020 a practical ethical decision-making framework for bank staff. Working with 120 volunteer staff from the five retail banks, together with other experts in the field, the IBCB developed and refined a series of five ethical dilemmas which demonstrate the challenges and biases which impede the process of ethical decision-making and provide insight into how it could be improved. Alongside this, the IBCB produced a DECIDE Framework to identify for bank staff the critical components of ethical decision making and to provide a useful support tool as they make decisions. It emphasises the importance of self-reflection and developing awareness of the cognitive biases and heuristics which impact our decisions and the ‘ethical blind-spots’ which arise. The expectation is that

DECIDE together with the ethical dilemmas will also serve to generate discussions on ethical decision making within the banks. The 2021 IBCB staff survey revealed that staff who had heard of the DECIDE Framework and used it are considerably more likely to reference positive influences on decision-making.[68] However, it also indicated that there was a need to raise awareness of the DECIDE Framework, to improve communications from the banks themselves and most importantly to ensure that its use becomes a matter of habit for all employees. Two future areas of focus for the Ethics & Behaviour workstream in coming months are SEAR and Ethical Artificial Intelligence in Banking.

In May 2021, the IBCB also published the results of a second survey of bank customers conducted in early 2021.[69] While the staff survey had demonstrated positive progress since 2018 on key aspects of internal culture, unfortunately this had not had a significant impact on the views of bank customers who continue to have low levels of trust in the sector. In particular, customers are sceptical as to the sector's commitment to social good and to acting with honesty and integrity. The customer survey measured public sentiment on the basis of four key drivers of trust; integrity, ability, purpose, and dependability.[70] While 42% of those surveyed believe banks will play a critical role in Ireland's economic recovery from the Pandemic, and respondents expressed faith on specific issues such as staff competency and handling of customer data, it was noteworthy that 43% indicated that their perception of banks has worsened

[68] Irish Banking Culture Board (n 34) 11.
[69] Irish Banking Culture Board, 'Public Trust in Banking Survey' (2021), irishbankingcultureboard.ie/publications/eist-public-trust-in-banking-survey.
[70] ibid. This study leverages the Edelman Trust Measurement (ETM) framework.

since the Irish Banking Crisis in 2008. Given the steps described earlier in this chapter which have been taken by the banks in the last 15 months, this failure to convince the public of their commitment is disappointing.

At the time of writing, the IBCB is working on a set of *Guiding Principles for Change* (Principles) for its member banks to be adhered to where there are significant changes in operating models and/or activities with potentially significant consequences for bank customers, staff, and/or the wider market. These Principles were affirmed by all five member banks and will be relevant in managing the market departures and branch closures referred to earlier. The aim of the Principles is to ensure that relevant change projects are managed in line with the IBCB's overarching objectives of promoting fair and transparent contracts for customers and staff, underpinned by ethics and accountability. The banks have agreed, subject to confidentiality requirements, to provide updates to the IBCB Board on relevant change projects explaining how they are adhering to each of the Principles. The Principles are composed of five broad categories: Behaviour & Culture; Corporate Citizenship; Communications; Structured Listening & Consultation; and Supports. They include: a commitment to take change decisions in accordance with the stated purpose and values of the bank, the commitments set out within the bank's Behaviour & Culture change road-map and the IBCB principles; a promise to seek to adhere to the spirit as well as the letter of the law in relation to their management of the project and their ensuing obligations to customers, staff and wider society; and recognition of the unique societal role of banks and a commitment to ensuring that relevant aspects of this role (e.g. the accessibility of banking services, the impacts on customers in a vulnerable position as a result of relevant change, support for the real economy etc.) are given explicit focus when implementing relevant change projects. The buy-in of all the banks to these Principles is significant. Although the Principles are not binding, they act in a similar way to 'comply or explain' corporate governance codes but with the added benefit of oversight by the IBCB Board. They also concretise the public interest role of banks referred to in section 4 above and put it up to the banks to make good on their commitments to their stated values at a time when it may be most challenging to do so.

6. Conclusion

The earlier chapter welcomed the actions of the banks during the first few months of the Pandemic, noting that they demonstrated their commitment to their customers and the wider community. It also asked whether this broader social focus would continue in the face of the economic challenges which were likely to flow from the Pandemic. Despite the difficult macroeconomic environment which prevails, this chapter describes how the banks appear to have maintained their commitment to their values and continued to 'walk the walk' in managing distressed debt, safeguarding the supply of credit, and dealing with customers on a day-to-day basis. There remains a strong emphasis on cultural leadership and senior managers are indicating their willingness to set the tone from the top, to commit their firms to ethical behaviour and to signal trustworthiness. Yet, despite this, the IBCB research suggests that this has not fully resonated with the public and there are demands for greater accountability in respect of senior executives in the financial services sector. Restoring and maintaining trust is a complex matter. It depends not just on actual ability, integrity, dependability, and purpose but on perceptions of these factors too. The reputations of the banking sector is subject to the vagaries of the economy, political debate, the behaviour of individual players in the financial services sector and the Pandemic to name just a few. The public anger which ensued in the wake of the very costly Banking Crisis rests just below the surface and is liable to bubble over upon any suggestion of inequity or misconduct.[71]

An important question to consider in the context of this chapter is how one might categorise the recently announced plans for a departure from the Irish market or a programme of branch closures. Is it a betrayal of customers and other stakeholders if banks consider that it no longer makes commercial sense to remain or to operate an extensive branch network? In the earlier chapter, reference was made to a category of actions taken to protect stakeholders in response to 'a supposed moral imperative that may conflict with profit maximisation'.[72] It noted that such actions involve 'uncompensatable costs' which do not lead to long-term shareholder value creation but create broader stakeholder value. It is possible that a decision by the banks in question to retain the status quo might have involved such costs. It is also possible that the banks may have taken the view, balancing the needs of all their stakeholders, that a search for sustainable value creation obliged them to take the decisions they did. In such a case, the question is whether a broader national public interest should trump the interests of these private entities. While the agreement of the banks to the IBCB's

[71] It is noteworthy that the IBCB's 2020 survey of bank customers reveals that the banking sector's net trust score is highest among the 18-24 year olds (the sector who were children in 2008) and decreases with age.
[72] Clarke (n 1) 142 referring to John Parkinson, *Corporate Power and Responsibility: Issues in the Theory of Company Law* (Oxford University Press 1995).

Guiding Principles for Change gives us reason to be optimistic in this regard, the old adage of 'trust but verify' comes to mind. The IBCB's proposal to conduct an impact assessment of the Principles at least an annual basis is sensible in this context. While the Minister emphasised the need to ensure the banking and financial system will effectively contribute to and support economic growth and employment in Ireland, he too acknowledged that it also has to be profitable to do this.[73] This is a complex situation and there is a clear need to have a discussion at a national level on the purpose of banks and the factors, including the emerging economic, technological and ESG risks, which will impact the way banking business is conducted in this country in the future. Given the importance of the stakes, it is hoped that this conversation can be informed, broad, open, and inclusive.

[73] Donohoe (n 15).

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14. Mothballing the economy and the effects on banks

Matthias Lehmann*

* * *

1. Introduction

The COVID-19 pandemic is creating unprecedented challenges for societies and the economy. As a result, the state is making a comeback. The crisis is a forceful reminder that the state is the ultimate holder of power. Around the world, legislators and governments have intervened on different levels.

2. The three-level model of state responses to COVID-19

At the first level, drastic measures have been adopted, like social distancing, closures of public buildings and lockdowns. Here, the state acts in its role as the guardian of its citizens' lives and health to contain the spread of the virus. In this context, different interests have to be weighed, for example, the chances of limiting the propagation of the virus against the economic

* Many thanks to Emeric Prévost, Jonas Schürger, Paul Eichmüller, Vanessa Kasper and Robert Vogelauer for the update of the manuscript. This article is current as of 1 May 2021.

fallout a lockdown produces. As a result of the measures taken, social and economic life has grinded to a halt.

At the second level, the state tries to limit the negative effects of the measures adopted at the first level by ‘pausing’ or ‘deep-freezing’ the economy. A key objective is to ‘mothball’ companies and business relationships for the duration of the crisis so they can reemerge after a couple of months as if the past had not happened. At this level, the state acts in its classic function as a regulator, although with rather unusual measures. Again, it needs to balance diverging interests: Is it really fair, for instance, to allow the debtor not to repay the capital? What if the creditor is itself in dire straits?

Some of the techniques that have been used for mothballing are as follows: (1) the rules on insolvency have been relaxed, e.g. the liability for wrongful trading[1] or the duty of the directors to apply for the opening of an insolvency procedure[2]; (2) ‘moratoria’ or ‘repayment holidays’ have been introduced for

[1] See, for example, Corporations Act 2001 (Australia), sec 588GAAA, as amended 2020.

[2] See, for example, *Gesetz zur Abmilderung der Folgen der COVID-19-Pandemie im Zivil-, Insolvenz- und Strafverfahrensrecht* (Germany), 27 March 2020 (*German COVID-19-Act*), Article 1 sec 1. In Germany, both grounds for the opening of insolvency proceedings - imminent insolvency and overindebetedness - were originally suspended. Since then, the suspensions have been gradually reduced. First, the suspension was limited to overindebtdness as a ground for initiating insolvency proceedings, while insolvent companies were obliged to start such proceedings. This suspension was further limited by an Act from 15 February 2021, which frees only those overindebted enterprises from the obligation to file for insolvency that qualify to receive COVID-state aid. For Austria see *4. COVID-19-Gesetz* (Austria), 4 April 2020 (*Austrian COVID-19 Act*), Article 37 sec 9 subsec 1 (which has been further prolonged several times, the last time in the Act changing the 2nd COVID-19 Judicial Supplementary Law, 24 March 2021, Article 6, until 30 June 2021). Yet in Austria, these exceptions have always applied only to cases of overindebtedness and not to those of imminent insolvency.

vulnerable debtors of loans, such as consumers or microenterprises;[3] (3) sanctions for not meeting contractual obligations have been mitigated or excluded, for instance by temporarily banning the termination of rental contracts[4] or the eviction of tenants[5] for failure to pay the rent. The most effective example of mothballing has been, perhaps, achieved by quite a simple measure: the Chinese extension of the New Year by a few days.[6]

Mothballing is not, however, comprehensive. The legislator is unable to stop life from going on. Employees need to be paid, food must be bought, children's mouths must be fed. Deep-freezing the economy cannot change these basic necessities.

This is why the state intervenes at a third level: this time as a kind of payer of last resort. It bails out companies, distributes subsidies, hands out loans, gives guarantees or pays cash directly to those in need. What the market used to deliver is now provided by the state. The bill for the taxpayer will be huge, but there is no alternative. The state is acting as the ultimate insurance provider for every part of society. In this context, important decisions need to be made. Which industries or companies should be bailed out, and on what terms? Who is to

[3] See, for example, *Austrian COVID-19 Act*, Article 37, sec 2; *German COVID-19-Act*, Article 5, sec 3.
[4] See, for example, *Austrian COVID-19 Act*, Article 37, sec 1 (the right to bring a claim for rent payments and to end the rental contract due to default of payment is deferred until 31 March 2021); *German COVID-19-Act*, Article 5, sec 2 (the right to end the rental contract because of default in rent is suspended until 1 July 2022, but not the payment of the rent itself).
[5] See for example *Austrian COVID-19-Act*, Article 37 sec 6 (suspension of eviction being effective until the end of COVID-19 restrictions or six months after the suspension was granted).
[6] See BBC, 'Chinese new year extended to contain spread of Coronavirus' (*BBC*, 27 January 2020), bbc.co.uk/programmes/w172wyb155yx99x.

benefit from a subsidy, and how much? Who is eligible for a loan or a direct payment?

The three levels on which the state intervenes, including the measures and the interests involved, are reflected in the following table.

	First Level	**Second Level**	**Third Level**
The function of the state	Guardian of order	Market regulator	Ultimate insurance
Type of intervention	Freezing social activity through: • social distancing • curfews • closures • travel restrictions	'Mothballing' the economy through: • alleviation of duties under insolvency law • moratoria on contractual obligations • limitations on termination of leases	Substituting the market through: • bailouts • subsidies • loans • guarantees • direct cash hand-outs
Interests at stake	• life & health • continuity of economic activity	• viability of businesses • income of shareholders and bondholders • interests of creditors	• viability of businesses • individual subsistence

The simultaneous strong state intervention at all three levels is unprecedented for Western economies. There have been previous emergencies, such as the oil crisis, the 9/11 terror attacks, or the global financial crisis. Yet, these had been triggered by a single event, giving the economy time to adapt to the new conditions. In comparison, the Coronavirus crisis is both extremely urgent and of a long and uncertain duration. The closest analogy seems to be war, but even during military conflict, economic activity continues; it merely shifts its focus to the production of arms and other war goods. The need for a complete 'hibernation' of the economy is a rather new phenomenon.

3. The exceptional role of financial markets and banks

There is one remarkable exception from mothballing: financial markets are continuing to operate in most countries. Disruptions have mostly been technical and short-term only. The continuity of trading should not be considered a coincidence but an essential policy objective of states. Financial markets operate as gauges of the future. They constantly evaluate the economic impact of the crisis and adjust prices. They also reallocate capital to where it is needed, for instance, from the producers of leisure goods to those of medical equipment. That is why they have so far been spared from hibernation.

This being said, some adaptions have been made. To illustrate, several European countries have imposed limitations on short selling activities to avoid the worst reactions to the pandemic.[7] These bans have been only temporary and were terminated as soon as they had served their purpose of limiting price

[7] See ESMA, 'ESMA issues positive opinions on short-selling bans by five jurisdictions' (Press release, 15 April 2020), esma.europa.eu/press-news/esma-news/esma-issues-positive-opinions-short-selling-bans-austrian-fma-belgian-fsma.

volatility.[8] Nevertheless, they were followed by other measures. The European Securities and Markets Authority (ESMA) thus decided to strengthen regulatory control over financial markets by lowering the threshold for the reporting of short selling position from 0,2% to 0,1% of the issued share capital traded on an EU regulated market.[9] The decision aimed at enabling national and European supervisory authorities to promptly and vigorously react in case of severe market disruption; it has been renewed no less than four times, eventually expiring on 19 March 2021. As reasons, ESMA cited GDP forecasts that gave sufficient ground for moderate optimism regarding the recovery, decreasing price volatility and the main EU stock indices being close to pre-pandemic levels.[10] These and other pinpointed, temporary interventions from regulatory authorities confirm the general trend: financial markets continue unbridled.

Similarly, banks continue to function during the pandemic. Though branches have been closed, online banking and ATMs

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[8] See ESMA, 'ESMA – Non-renewal and termination of short selling bans by Austrian FMA, Belgian FSMA, French AMF, Greek HCMC, Italian CONSOB and Spaninsh CNMV' (Press release, 18 May 2020), esma.europa.eu/press-news/esma-news/esma-—-non-renewal-and-termination-short-selling-bans-austrian-fma-belgian-fsma.

[9] ESMA, *ESMA Decision on thresholds for reporting net short positions* (16 March 2020) (ESMA70-155-9546), esma.europa.eu/sites/default/files/library/esma70-155-9546_esma_decision_-_article_28_ssr_reporting_threshold.pdf. An analogous measure has been taken for the whole European Economic Area (EEA): see EFTA Surveillance Authority, 'ESA: The financial markets and Covid-19' (Press release, 16 March 2020), eftasurv.int/newsroom/updates/esa-financial-markets-and-covid-19.

[10] See ESMA, 'ESMA to allow decision on reporting of net short position of 0.1% and above to expire' (Press release, 15 March 2021) esma.europa.eu/press-news/esma-news/esma-allow-decision-reporting-net-short-position-01-and-above-expire; for the parallel announcement by the EFTA Surveillance Authority, see eftasurv.int/newsroom/updates/temporary-requirement-net-short-position-holders-disclose-positions-01-and-above.

remain available. Activity in wholesale banking and the provision of credit have not merely carried on but have actually increased in volume. Today, banking services are more in demand than ever: Companies and private individuals desperately need liquidity during the period of mothballing.

The state has even enlarged the function of banks by engaging them for concluding loan agreements with and disbursing funds to those in need. In this context, the banks have been partially freed from the risk of defaults. In the UK, for instance, the Coronavirus Business Interruption Loan Scheme (CBILS) delivers state guarantees for loans to small enterprises. In Germany, the state-owned KfW is acting as guarantor for up to 90% of loans made available to companies finding themselves in financial difficulties due to the pandemic. In France, any company facing financial hardships due to the pandemic may benefit from a state guarantee covering up to 70%, or 90% in the case of small and medium enterprises (SMEs), of the overall amount of a loan extended either by a credit institution or a crowdfunding platform.[11] Banks and other credit intermediaries have thus become paramount leverageable entities for the survival of a forcibly mothballed economy.

4. A hard-hitting test on banks' resilience

Besides implementing state programmes at the second level mentioned above, banks are widely expected to provide credit and liquidity from their own resources. But can they?

In general, the state of the banking sector is rather good, thanks to the considerable capital adequacy requirements imposed in

[11] The scheme has been introduced by Article 6 Law no. 2020-289 of 23 March 2020 and the implementing decree of 23 March 2020 (amended).

the aftermath of the global financial crisis.[12] The quality of the banks' 'own funds' has been improved; countercyclical and capital conservation buffers have been built up; liquidity requirements and leverage ratios have been introduced. In addition, a new resolution regime ensures that shareholders and creditors rather than the taxpayer will bear the brunt of a bank failure. All of this makes the banking sector more robust in times of crisis, especially when compared to other sectors, such as manufacturing or leisure services.

This relatively satisfactory situation has been further improved by additional measures to shore up bank capital. Regulators have recommended that banks defer discretionary dividend payments and share-buybacks.[13] They have also cautioned against handing out generous bankers' bonuses.[14]

Whether all of this is sufficient to weather the current COVID-19 crisis is highly doubtful. The pandemic will test the stability of the banking sector to its limits. The measures taken after the global financial crisis were principally targeted at systemic risk, i.e., risk that is endogenous and specific to the structure and

[12] For an overview, see IMF, 'Global Financial Stability Report, October 2018: A Decade After the Global Financial Crisis: Are we Safer?' (October 2018), elibrary.imf.org/view/IMF082/25319-9781484375594/25319-9781484375594/ch02.xml; FSB, *Implementation and Effects of the G20 Financial Regulatory Reforms* (3rd Annual Report, 3 July 2017), fsb.org/wp-content/uploads/P030717-2.pdf.

[13] See, for example, Recommendation of the ECB of 27 March 2020 on dividend distributions during the COVID-19 pandemic and repealing Recommendation (ECB/2020/1) (ECB/2020/19), OJ C 102I, 30.3.2020, 1.

[14] UK Prudential Regulation Authority, 'Statement on deposit takers' approach to dividend payments, share buybacks and cash bonuses in response to Covid-19' (31 March 2020), bankofengland.co.uk/prudential-regulation/publication/2020/pra-statement-on-deposit-takers-approach-to-dividend-payments-share-buybacks-and-cash-bonuses.

functioning of the financial system.[15] In contrast, the COVID-19 crisis can be categorised as a 'common shock' that is not rooted in the financial system but exogenous. It is true that one of the functions of capital requirements precisely is to shield banks against exogenous shocks.[16] Yet, the coronavirus pandemic is no ordinary crisis. Several factors make it especially challenging.

- First, the crisis is global. It affects every country in the world, from Australia to Sweden. Virtually no place on the planet was spared.
- Second, the pandemic hits all sectors. It shocks both the supply and demand side. Another peculiarity of the COVID-19 crisis is that it befalls areas of the economy that were hitherto considered completely distinct: from restaurants, universities, to the oil industry. It thereby exposes a previously hidden correlation between them.
- Third, the timing of the occurrence of such a crisis was hard to foresee. Only a few expected in January 2020 that a pandemic might hit the world economy. The end of the crisis and the impact on business is equally hard to predict.

These characteristics of the COVID-19 crisis explain why it is especially challenging for credit institutions. The pandemic numbs the effectiveness of measures designed to make the banking system safer and more resilient.

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[15] On the notion of systemic risk, see Olivier De Bandt and Philipp Hartmann, 'Systemic Risk: A Survey' (2000) ECB Working Paper Series No. 35, papers.ssrn.com/sol3/papers.cfm?abstract_id=258430; Jean-Pierre Fouque and Joseph A. Langsam, *Handbook on Systemic Risk* (Cambridge University Press 2013) xxi; Steven L Schwarcz, 'Systemic Risk' (2008) 97 Georgetown Law Journal 193.

[16] Daniel K. Tarullo, *Banking on Basel: The Future of International Financial Regulation* (Peterson Institute 2008) 18 (highlighting that an exogenous shock may diminish the value of whole categories of bank assets).

- First, risk diversification is simply no longer working. Previously, banks were able to offset losses in one region or sector, at least partially, with gains in other regions or sectors. Now, the losses smash the banking book all over.
- Second, the value of collateral is declining. Securities and mortgages, which make up the bulk of loan collateral, have previously been considered unrelated to the credit risk of the borrower. However, during the COVID-19 crisis, their value has decreased as well. Accordingly, the safety net is no longer reliable.
- Third, due to the lack of foreseeability, rating models and other methods of gauging risk are failing. There is simply insufficient data on the economic consequences of the disease due to its unprecedented nature and proportions. The most recent comparable pandemic, the Spanish flu, occurred in 1918-1919. Little is known about its precise economic impact, especially given that the outbreak coincided with the end of WWI. It can therefore hardly be used to model the risks of the current crisis.
- Fourth, state intervention further compounds the problems. Not only do the measures taken by states at the first level harm the economy, but those at the second level have an equally negative impact on the banking sector. Banks have written most loans. This means that emergency legislation suspending repayments hits them hard. The state is granting relief through mothballing, but the banking system is footing the bill.

To ease the burden on banks, states have taken the unusual step to relax capital requirements. Countercyclical risk buffers have been reduced, sometimes even to zero.[17] Other risk management

[17] See for example Central Bank of Ireland, 'Statement: Central Bank of Ireland' (18 March 2020), centralbank.ie/news/article/press-release-statement-central-bank-of-ireland-18-march-2020.

measures, such as the qualitative market risk multiplier,[18] have also been relaxed. Scheduled stress tests have been suspended until 2021,[19] while planned reforms to strengthen regulation have been postponed.[20]

The European legislator followed suit by formally amending some specific CRR[21] provisions through the so-called 'CRR Quick-Fix Regulation',[22] which entered into force on 27 June 2020. The regulation introduced urgent relief measures regarding banks' prudential requirements to ensure that banks will stay able to provide the economy with sufficient liquidity during the COVID-19 crisis. Among these measures, there was the extension of the transitional arrangements until the end of 2024, allowing banks to mitigate the potentially negative consequences arising from the implementation of International Financial Reporting Standard (IFRS) 9 provisions. The

[18] See ECB, 'ECB Banking Supervision provides temporary relief for capital requirements for market risk' (Press release, 16 April 2020), bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200416~ecf270bca8.en.html.

[19] See for example EBA, 'EBA statement on actions to mitigate the impact of COVID-19 on the EU banking sector' (Press release, 12 March 2020), eba.europa.eu/eba-statement-actions-mitigate-impact-covid-19-eu-banking-sector.

[20] BCBS, 'Basel Committee and IOSCO announce deferral of final implementation phases of the margin requirements for non-centrally cleared derivatives' (Press release, 3 April 2020), bis.org/press/p200403a.htm.

[21] 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 and amending Regulation (EU) No 648/2012 [2013] OJ L 176, 1–337. This regulation was later amended by Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 ('CRR II'), [2019] OJ L 150, 1–225.

[22] Regulation (EU) 2020/873 of the European Parliament and of the Council of 24 June 2020 amending Regulations (EU) No 575/2013 and (EU) 2019/876 as regards certain adjustments in response to the COVID-19 pandemic [2020] OJ L 204, 4.

prudential burden on banks may have indeed increased as the result of IFRS 9, which introduces *inter alia* an Expected Credit Loss (ECL) accounting model (in contrast to the current incurred loss accounting model) for the calculation of banks' capital requirements. Other notable relief measures are the introduction of a preferential prudential treatment for publicly guaranteed loans, the possibility to omit certain exposures to central banks, the acceleration of the application of a more favourable treatment for certain loans backed by pensions or salaries as well as for certain exposures to SMEs to incentivise lending to them. Although such relief measures and nudges for the provision of countercyclical liquidity prevent the economy from shrinking suddenly, their side effect is an increase of the exposure, especially of European banks to sovereign debt.[23] This needs to be taken seriously: As is known from the recent past, one crisis may hide another.

Also, the relaxation of prudential requirements made an alteration of banks' reporting obligations necessary. To this effect, the European Banking Authority (EBA) issued some interim guidelines,[24] matching the amendments introduced by the CRR Quick-Fix Regulation, until the revised Implementing Technical Standards (ITS) on reporting v3.0 in light of the COVID-19 crisis start to apply in June 2021. Precise reporting is all the more crucial, as the European Central Bank has found in its recent Targeted Review of Internal Models (TRIM)

[23] Martin Arnold, 'Italian and French banks revive 'doom loop' fears with bond buying' (*Financial Times*, London, 6 April 2021), ft.com/content/fde7833a-8283-45b8-97ae-9104e1c974cd.

[24] EBA, *Guidelines on supervisory reporting and disclosure requirements in compliance with the CRR 'quick fix' in response to the COVID-19 pandemic* (11 August 2020) EBA/GL/2020/11.

study[25] that significant EU institutions using internal models to estimate their own funds' requirements have been underreporting risks.[26]

While the CRR Quick-Fix Regulation was meant to provide temporary relief, banks' prudential matrix is undergoing fundamental changes to face the now lasting pandemic emergency. On 31 March 2021, the European Supervisory Authorities thus issued a joint report on risks and vulnerabilities in the EU financial system calling for banks and supervisors to prepare for an expected deterioration of asset quality, a lasting environment of low interest rate, a period of valuation shocks and of increased redemption for investment funds, while also advocating a cautious policy of dividends and share buy-backs, as well as a thorough and forward-looking lending risks assessment.[27]

All of these measures take immediate pressure from the banking book. Yet, they only allow credit institutions to deplete their own funds and do nothing to strengthen their capital base. The question now on the table is how to manage the transition back to the 'normal' regulatory framework without any disastrous shock resulting from an abrupt need to raise capital.

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[25] ECB, *TRIM Project Report* (April 2021), bankingsupervision.europa.eu/ecb/pub/pdf/ssm.trim_project_report~aa49bb624c.en.pdf.

[26] See Reuters Staff, 'ECB finds top euro zone banks underreport risk' (*Reuters*, Frankfurt, 19 April 2021), reuters.com/article/ecb-banks-capital/ecb-finds-top-euro-zone-banks-underreport-risk-idUSL8N2MC1SD.

[27] European Supervisory Authorities (EBA, EIOPA, ESMA), *Joint committee report on risks and vulnerabilities in the EU financial system* (31 March 2021) JC 2021 27, esma.europa.eu/sites/default/files/library/jc_2021_27_jc_spring_2021_report_on_risks_and_vulnerabilities.pdf.

5. The 'bail-in' regime is unsuitable for this crisis

The double-attack of the ongoing crisis and the intervention of the state leads banks ever closer to the edge. At some point, they may break. This raises a question: Should the state intervene by shoring up the capital of banks with taxpayer money? In other words, should it act at the third level as the ultimate insurance, also for the banking system?

Resolution regimes were designed to precisely avoid this: the need for the state to bail out the banking sector.[28] They were created to respond to the 'too big to fail' conundrum, which meant that taxpayer money had to be spent on banks to avoid a deepening of the crisis. The underlying idea of resolution regimes was that this must not happen again in the future: moral hazard should be avoided at all cost; bankers should no longer be able to privatise gains and socialise losses.[29]

These policies – designed in the context of the global financial crisis – are however not appropriate in the context of the COVID-19 pandemic. The latter was not caused by the banks' own doings. It is not the consequence of their risky behaviour or opaque transactions.

Furthermore, the state now places additional strain on the banks' balance sheets. In order to achieve macroeconomic goals, regulators are actively interfering with commercial

[28] See Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms (*EU Bank Recovery and Resolution Directive – BRRD*), [2014] OJ L 173/190; and Title II of the Wall Street Reform and Consumer Protection Act 2010 (*Dodd-Frank Act*), Publ. L. 111–203, 124 Stat. 1376.
[29] See G20, 'G20 Leaders Statement: The Pittsburgh Summit', (Pittsburgh, 24–25 September 2009) No. 13; see also FSB, 'Key Attributes of Effective Resolution Regimes for Financial Institutions' (15 October 2014), Preamble.

decision-making and risk-provisions by encouraging banks to spend more capital. For instance, the Basel Committee has recommended banks use the 'flexibility' inside the accounting and auditing standards to mitigate the effect of the COVID-19 crisis.[30] The UK Prudential Authority has even called on banks to spend their capital on writing new loans rather than creating reserves to absorb losses on loans.[31] The efforts of banks to build up capital for non-performing loans are reasonable from a microprudential viewpoint. Yet, they are purposefully discouraged because they run counter to the state's goals of mothballing the economy and injecting capital into businesses. This time, the failure of some banks will not be their fault, but rather the result of their actions in the public interest as demanded by regulators.

It follows that the application of the bailing-in tool, a core feature of the resolution regimes, will not always be appropriate in the current crisis. The more decisions are taken in the public interest and at the behest of financial regulators, the less it is justified to make shareholders and creditors bear the brunt of the banks' demise. Therefore, it cannot be categorically excluded that the state as the ultimate insurer intervenes at the third level to save banks where this is necessary.

Unfortunately, the law as it currently stands does not allow for such an exceptional bail-out. It provides for the automatic applicability of bail-in and other resolution measures when a bank is failing or likely to fail. These are available irrespective

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[30] BCBS, 'Basel Committee sets out additional measures to alleviate the impact of Covid-19' (Press release, 3 April 2020), bis.org/press/p200403.htm.
[31] Stephen Morris, David Crow and Matthew Vincent, 'BoE Warns Bank Loan Reserves Risk Choking Business Funding' (*Financial Times*, 26 April 2020), ft.com/content/75767049-edfb-4074-942c-f9ce4d07f861.

of the reasons for the failure; the law is not interested in how the failure came about.

One way to avoid the strict application of the bail-in tool and other resolution measures would be a ‘precautionary recapitalisation’.[32] Because states could soon reach their financial limits as a result of such a recap, it has been suggested that the ESM could be used as a source of finance.[33] However, this approach would lead to a further extension of the already problematic precautionary recap. The instrument was never intended for such large-scale operations. Its use in the crisis may remove the last remaining scruples to circumvent the BRRD in the future for political reasons. Also, the magic words ‘precautionary recap’ leaves up in the air the all-important criteria of how money should be distributed.

Instead, we need a change of the BRRD. The rigid resolution framework was designed to prevent a repeat of the global financial crisis of 2008. It is a truism that every regulation is written with the last crisis in mind. In light of the current situation, the law needs to be changed urgently. It must be made clear under which conditions states may bail out banks that are failing or are likely to fail because their capital has been depleted due to the measures taken in response to the pandemic, especially when banks have been encouraged by regulators to use their capital for the distribution of new loans.

[32] BRRD, Article 32(4)(d); see Rainer Haselmann and Tobias Tröger, ‘When and how to un- wind COVID-support measures to the banking system?’, SAFE White Paper no. 83 (March 2021), Economic Governance Support Unit (EGOV) Directorate-General for Internal Policies – European Parliament (PE 659.649).

[33] Cf ESM-Treaty, Article 15(1).

The change requires the introduction of a crucial dividing line in resolution law. A distinction needs to be made between banking crises that were the result of the risk-taking decisions of the banking institutions themselves and those that have been induced by external and unforeseeable circumstances, such as the COVID-19 outbreak and the measures taken against them. The rules on state aid provide an exception for measures 'to make good the damage caused by natural disasters or exceptional occurrences' (Art 107 Treaty on the Functioning on the European Union). A similar exception must also be included into the resolution framework. If banks acted in a crisis in the general interest and sacrificed their capital for restarting the economy, it should be possible for the state to bail them out.

6. The future: banking after COVID-19

The COVID-19 crisis is another forceful demonstration of the intimate connection between states and banks, one which confirms a worrying trend that has developed over the past few years. The level of regulatory interference with bank governance and own funds has constantly been increased.

Even before the current crisis unfolded, regulators had already begun fine-tuning the prudential regulation of risk-taking activity by banks in minute detail. Basel III and its follow-ups give them wide leeway in steering the banks' behaviour. Some have therefore compared banks with highly regulated 'utilities', such as water, electricity and communication services providers.[34]

[34] John M Schiff, 'Is Basel Turning Banks into Public Utilities?' (2015) 3 The Journal of Financial Perspectives 04.

A number of authors do not see this development as worrying but rather applaud it. They support applying certain principles of utilities law to banks, such as democratic governance or fair and equal fee setting.[35] In their view, banks should no longer be private property.[36]

From an economic perspective, one can only warn against such proposals. The function of banks is to allocate capital to where it is most needed and will be best utilised. Despite their failings, privately-owned banks have fulfilled this task rather well to date. At any rate, they are much better able to do so than the state. The decision as to whether to grant credit should remain commercial and not become political.

If the banking sector is to remain private, it is important that shareholders and creditors are not made to bear the burden of measures taken in the pursuance of macroeconomic policies. Credit institutions are not funds that regulators can raid to support the economy in times of crisis. In the name of the principle that decision-making and liability should go hand in hand, some compensation for banks acting in the public interest will be required. Without it, one needs to seriously worry about the future of the banking business, because nobody would want to become a shareholder anymore.

The current COVID-19 crisis is a reminder that the market and the state are two complementary forces. The latter not only sets

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[35] Philip Molyneux, 'Are Banks Public Utilities? Evidence from Europe' (2017) 20 Journal of Economic Policy Reform 199 (advocating heavier regulation of bank pricing, profitability and service provision); Alan M White, 'Banks as Utilities Symposium: The Promise and Perils of Convergence in Financial Regulation and Consumer Protection' (2015) 90 Tulane Law Review 1241 (suggesting banks should be regulated to reduce income inequality).

[36] Cf White (n 35) 1268 ('Banks are not private property.').

the conditions for the functioning of the former but also acts as an emergency power generator where the market fails. It is, however, imperative to return to the market-driven system once the COVID-19 crisis has been overcome. Private actors will need to resume their role as the prime decision-maker on questions such as to whom to grant loans, on what terms, and against which collateral. While regulatory intervention during the crisis was inevitable, regulators should not take over bank governance indefinitely. In the post-COVID-19 setting, they should limit themselves again to requiring minimum capital as a safety net against micro- and macro-risks.

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15. A Post-COVID Reformed EU: New Fiscal Policies Preserving Financial Stability and the Future of the Banking Sector

Luís Silva Morais*

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1. A new type of systemic crisis: introductory remarks

1.1. Introductory remark and overview of analytical framework

1.1.1. 2020 has proven to be a landmark and defining year, probably marking the beginning of a 'shorter twenty first

* The views in this Article are entirely personal and academic and do not arise in any manner whatsoever from the author's institutional affiliations at SRB (Single Resolution Board) and ASF (Portuguese Insurance and Pension Funds Supervisory Authority). The cut-off date for relevant information and developments included therein is 2 June 2021.

century' in the same way as the 1914-18 First World War is frequently referred as marking the beginning of a 'shorter twentieth century', given the range of transformations it induced.[1] In fact, not much longer than a decade after the great financial crisis (GFC) of 2007-2008, which in the EU was prolonged and evolved towards a sovereign debt crisis, intertwined with a banking crisis,[2] and shortly after the momentous anniversary of the second decade of the Euro, a new and dramatic international economic crisis has unexpectedly erupted. This 2020-2021 crisis bears in common with the previous one a daunting perspective of systemic risk and of destruction of wealth and employment, and, from an EU standpoint, critical challenges in terms of providing an adequate response albeit in the context of widely acknowledged limitations of the governance and institutional structures of the European and Monetary Union (EMU).

Conversely, the evolution of the key *policy principles* of EMU and its related institutional fabric, leading, in my view, to *an actual transformation of the nature of the EMU after the last crisis*, have much better equipped it cope with the current turmoil. Taking stock at this point of more than one year of pandemic crisis it can actually be argued that these renewed

[1] The term was initially proposed by Iván Berend (Hungarian Academy of Sciences) but definitely coined by Eric Hobsbawm. See Eric J Hobsbawm, *The Age of Extremes: The Short Twentieth Century, 1914–1991* (London, 1995).

[2] On this idea of a sovereign debt crisis, intertwined in the EU with a banking crisis, see, *inter alia*, Christian Scheinert, 'Vicious circles: The interplay between Europe's financial and sovereign debt crises' European Parliament Think Tank Briefing (6 June 2016); Philip R Lane, 'The European Sovereign Debt Crisis' (2012) 26(3) The Journal of Economic Perspectives 49-67; Damiano Sandri and Ashoka Mody, 'The Eurozone Crisis: How Banks and Sovereigns Came to Be Joined At the Hip' (1 November 2011) IMF Working Paper.

policy principles for governing the EMU – painfully built over the preceding economic shock – have provided the necessary normative, regulatory, and institutional basis for a timely European reaction to such crisis, effectively avoiding the worse scenarios (in spite of the successive cycles of the pandemic and corresponding lockdowns of economic activity). This Chapter purports to discuss the key contribution of this *transformation of policy principles of governance of EMU* – not always acknowledged as such in overall terms – to the European relative success in containing to worst potential effects of the crisis. Complementarily, we shall – more briefly - discuss the extent to each it will provide an actual basis for a solid and not excessively uneven economic recovery and the possible need of further reforms of that overall governance (in the wake of the game changer represented by COVID-19 vaccination which built its momentum between the first and the second quarters of 2021,[3] after a rocky and much criticized start). In that context, the risks and opportunities experienced by the EU banking sector as a key factor in overcoming the COVID-19 crisis and spearheading a solid and widespread economic recovery are also discussed.

Avoiding either too much optimist or too much pessimism, and aiming towards *realism* which should be the cornerstone of the reaction to a widespread crisis, at the start of the COVID-19 shock we were in a better position to tackle this crisis (at EU level) and, at the same time (somehow paradoxically), in a worse position to cope with it (at worldwide level), in

[3] On the European vaccination program, see, *inter alia*, Jacob Funk Kirkegaard, 'The European Union's troubled COVID-19 vaccine rollout' (*PIIE Realtime Economic Issues Watch*, 5 March 2021), piie.com/blogs/realtime-economic-issues-watch/european-unions-troubled-covid-19-vaccine-rollout.

comparison with what happened at the close of the first decade of twenty first century.

In fact, it may be recalled that at the height of the previous great financial crisis (GFC), in the aftermath of the failure of the Lehman Brother in 2008, a coordinated international response was somehow achieved at the level of a landmark London G20 summit, leading to some decisive actions in the US, the EU, and elsewhere, oriented towards reforming the world's banking system, rewriting international rules on banks' capital, and obtaining some degree of convergence on fiscal stimulus measures.[4] Contrasting with this precedent, as duly emphasized by some of the key political protagonists of such G20 response, no comparable coordinated response at that level occurred immediately in the context of the current crisis, at a critical moment in which coordinated efforts to find a vaccine and conciliate sanitary measures, beside agreeing on a joint approach to the use of government spending to boost growth, would be more necessary than ever (considering the nature of crisis).[5] Conversely, it may be argued that political and institutional developments in the course of 2020 improved the willingness to cooperate internationally and that we have witnessed an unprecedented international wave of scientific and technical research that has allowed – in spite of persisting risks due to successive mutations of COVID-19 virus and other

[4] On the G20 response to the great financial crisis, see, *inter alia*, Andrew F Cooper and Colin I Bradford Jr (2010), 'The G20 and the Post-Crisis Economic Order' (June 2010) CIGI G20 Papers No 3, cigionline.org/sites/default/files/g20_no_3_0.pdf; Barry Eichengreen and Richard Baldwin (eds), *What G20 leaders must do to stabilise our economy and fix the financial system* (Centre for Economic Policy Research 2008).

[5] See on this Gordon Brown, 'In the coronavirus crisis, our leaders are failing us' (*The Guardian*, 13 March 2020), theguardian.com/commentisfree/2020/mar/13/coronavirus-crisis-leaders-failing-gordon-brown.

factors – the launching of COVID-19 vaccination in a record time.[6]

On the contrary, as aforementioned, at EU level the GFC and the subsequent sovereign debt crisis led, albeit in a protracted manner and following a still much incomplete roadmap, to a *set of reforms of the structure and governing principles of EMU*, which should ensure it is better equipped this time – particularly in the Euro area – to deal with the current emergency situation in order to contain economic recession due to COVID-19 lockdowns, avoid its evolution towards an actual depression, and launch the seeds of a wide and transformative recovery. *The real issue here is to ascertain to what extent the previous reform and transformation of EMU and the related processes of building the European Banking Union have actually gone far enough to frame not only a proper and balanced European response to the crisis* but also the *launch-pin of a widespread economic reform which does not aggravate the European position as lagging behind the US and China in a post COVID-19 word.*

1.1.2. With that overriding question in mind, I purport to take a step back and try to put into perspective (*infra*, section **2.**) the extent of the recent evolution of the *key policy principles of EMU* and of the very *nature of EMU*, thereby envisaging how much room may exist to decisive answers to the current crisis and subsequent economic recovery in terms of monetary policy in combination with fiscal policy. The critical answer to be found is to establish if the undeniable changes undergone by

[6] See, as an illustration of a new climate of international cooperation, EC, 'Rome Declaration' (Global Health Summit, Rome, 21 May 2021), global-health-summit.europa.eu/rome-declaration_en.

EMU in the course of the last decade have truly allowed the emergence – at least partially - of what may be designated as a new *economic and financial stabilization function*.[7] To phrase it in a slightly different manner, what is at stake is ascertaining if the changes undergone by EMU structures to ensure, with a difficult learning curve, some degree of shock absorption in the context of the last financial crisis, actually have the potential to absorb major economic shocks of the type the COVID-19 sanitary crisis is bound to induce. As in rather prophetic terms Daniel Gros argued it 2014 '*what the eurozone really needs is not a system that offsets all shocks by some small fraction, but a system that protects against shocks that are rare, but potentially catastrophic*.'[8] *Reality never disappoints* us, to quote the Spanish writer and theologian Pablo D'Ors, and the crucial test of a rare and potentially catastrophic shock has come sooner than expected.

The aforementioned *stabilization function* (comprehending financial stability) must, as such, involve new goals and instruments of monetary policy, of fiscal policy and a proper acknowledgment of the paramount role of the banking sector

[7] I refer here to a concept of idea of *stabilization* function in the EU, going much beyond the specific concept underlying the European Financial Stabilisation Mechanism (EFSM) for eurozone members offering macroeconomic support to countries threatened or experiencing severe financial difficulties. On this idea of *stabilization function* see, *inter alia*, Jorge Nuñez Ferrer and Cinzia Alcidi, 'Should the EU budget have a stabilization function?' (30 May 2018) CEPS Policy Brief, ceps.eu/ceps-publications/should-eu-budget-have-stabilisation-function; Alfred Katterl and Walpurga Koehler-Töglhofer, 'Stabilization and shock absorption instruments in the EU and the euro area –the status quo' (2018) Österreichische Nationalbank Monetary Policy & the Economy Q2/18.

[8] See Daniel Gros, 'A fiscal shock absorber for the eurozone? Lessons from the economics of insurance' (*VoxEU CEPR*, 19 March 2014), voxeu.org/article/ez-fiscal-shock-absorber-lessons-insurance-economics.

for that function (in a normative context in which, strangely, the framework and functions of the banking sector are nearly absent from the EU Treaties in spite of the core political dimension of such sector, which is further highlighted in a context of crisis). That assessment, in turn, will pave the way to discuss succinctly the potential *mix of monetary and fiscal measures* to be adopted in the eurozone, considering, as much as possible, both its legal and its political feasibility, and, above all, the extent to which the fiscal pillar may supplement the actions of the monetary pillar (*infra*, section **3.**).

1.1.3. This intersects the rather intractable debate on EU *mutualisation* of debt and related fiscal responsibilities or commitments (*lato sensu*),[9] in terms of an overall *financial burden-sharing* between the EU and its constituent parts. In fact, although the significant evolution of monetary policy in the course of recent years (corresponding, as argued *infra* section **2.**, to a *qualitative transformation* of this policy albeit still subject to legal uncertainty e.g. on account of intervention of national Courts, namely the '*Bundesvertassungsgericht*' in Germany) has led the ECB to develop what in effect represents an *atypical form of mutualisation* [in the form of *quantitative easing*, through which '*a shared liability (cash) has been swapped for the sovereign bonds of individual euro-zone*

[9] See for the general terms of such debate on mutualisation, Alfredo Arahuetes and Gonzalo-Gómez Bengoechea, 'Debt mutualisation, inflation and populism in the Eurozone' (5 April 2018) ARI 45/2018; Agnès Bénassy-Quéré et al., 'Reconciling risk sharing with market discipline: A constructive approach to euro area reform' (January 2018) CEPR Policy Insight No 91, bruegel.org/2018/01/reconciling-risk-sharing-with-market-discipline-a-constructive-approach-to-euro-area-reform/ .

countries'[10]], the legal constraints or hurdles to overcome in terms of *mutualisation* at the level of the fiscal pillar and of the monetary pillar are still somewhat different. Nevertheless, I shall argue that at the present crossroad it should be avoided at all costs a too conceptual discussion on a *one way out model of EU fiscal response to the crisis* with an overemphasis on accepting *mutualisation* (as the one epitomised by the initial discussion on the so called 'Corona-bonds'[11]) or on an *explicit, direct, and pure model of burden-sharing* in a new type of *fiscal union* built overnight. Conversely, it will be argued that we should build further on the mix of compromise, but in some cases transformative, solutions painfully reached at the height of the COVID-19 crisis as a basis for reinforcing the fiscal pillar of EMU and, above all, for starting a new virtuous evolving-path towards a more robust financial union that might be deepened as much as possible without the high political costs of Treaty changing.

1.1.4. Finally, in connection with such responses, I purport to discuss, however very briefly, the role of the banking sector in the EU reaction to the crisis and the ways in which, at the same time, this sector will be foreseeably affected by this economic recession and the conditions of the incoming recovery. In fact, the particular nature of this crisis entails undeniable risks for the functioning of the European banking sector but also significant

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[10] See, stating that view to which I largely subscribe with the caveat referred *supra*, 'Why the Euro is more durable than it looks' (*The Economist*, 25 April 2020), economist.com/finance-and-economics/2020/04/25/why-the-euro-is-more-durable-than-it-looks.

[11] On the so called 'Corona bonds', as initially discussed after the irruption of the Covid-19 crisis, see, *inter alia*, Lorenzo Bini Smaghi, 'Corona bonds – great idea but complicated in reality' (*VoxEU CEPR*, 28 March 2020), voxeu.org/article/corona-bonds-great-idea-complicated-reality.

opportunities for its further transformation in the course of the overall restructuring it was still enduring when entering 2020, with the gradual and incomplete implementation of the various building blocks of the Banking (Union), in connection with a new normative Banking Package,[12] and a much uncertain and nebulous Capital Markets Union (*infra*, section **4.**).

1.2. A new type of systemic crisis in the EU and worldwide

1.2.1. The measures of lock-down adopted in EU member States in response to the COVID-19 pandemic have in effect originated a spiral of economic consequences that, as underlined by the former ECB President (and current Italian Prime Minister) Mario Draghi, inevitably induces a serious recession, with the risk of such recession '*morphing into a prolonged depression, made deeper by a plethora of defaults leaving irreversible damage'*.[13]

The key outstanding doubt under the current conditions is the duration of the recession and the shape and rhythm of the possible recovery – namely a 'u-shaped' recovery, with a larger period of economic contraction and stress, or a 'V-shaped' recovery with a quicker and more dynamic recovery after an acute moment of contraction (albeit very limited in time). In fact, another distinctive feature of this COVID-19 crisis concerns the sheer level of uncertainty and the extreme technical difficulty in producing reliable projections. Such difficulty – not entirely eliminated by the introduction of

[12] I refer here to the Banking Package adopted by the EU in 2019, comprehending revised rules on capital requirements (CRR II/CRD V) and on resolution (BRRD/SRM).

[13] See Mario Draghi, 'We face a war against coronavirus and must mobilise accordingly' (*Financial Times*, 25 March 2020), ft.com/content/c6d2de3a-6ec5-11ea-89df-41bea055720b.

vaccination programs by the end of 2020 - has, in itself, a negative spill over effect in terms of overall *confidence*, which, in turn, is bound to have appreciable repercussions in the financial sector, especially the banking sector (whose activities are intrinsically fuelled by the levels of *confidence* of the stakeholders in the sustainability of the most relevant parts of this sector and of the economic activities supported by the said sector).

Actually, the COVID-19 crisis has arisen from two cumulative economic shocks – a *demand-side* and a *supply-side shock*, but to make matters even more complicated the demand-side shock produced by the pandemic has an entirely different nature from the one which occurred in the preceding crises (including the great financial crisis of 2007-2009).

In the previous European crisis, and as it normally happens, the contraction of demand arose due to a widespread shortage of income (which in itself was due to stabilization policies implemented by the Member-states more severely affected by the sovereign debt crisis). Conversely, in the COVID-19 crisis the demand-side shock did not result from a shortage of income but from a drastic interruption of the economic circuit (as consumers could not access goods and services through the normal circuits due to the confinement measures successively adopted in a non-coordinated fashion by the various EU member-States)[14].
At the same time a supply-side shock occurred on account of a drastic reduction of the availability of the labour force, due

[14] See on this Isabel Schnabel, 'The sovereign-bank-corporate nexus – virtuous or vicious?' (Speech at the LSE conference on 'Financial Cycles, Risk, Macroeconomic Causes and Consequences', Frankfurt, 28 January 2021), ecb.europa.eu/press/key/date/2021/html/ecb.sp210128~8f5dc86601.en.html.

simultaneously to the prevailing health situation and contagion and to the constraints induced by physical confinement (in spite of the telework environment quickly adopted by undertakings whenever feasible).

1.2.2. From another perspective, the particular features of this crisis, as succinctly described *infra*, have made clear – in an extreme form – the high potential for *systemic risk* in the current highly integrated and interdependent international economy outside the banking sector (*a potential for systemic risk which may foreseeably take other forms other than the COVID-19 pandemic in years to come*).[15]
In fact, if it is true that the high level of interdependence between banks makes them particularly prone to *systemic risk*,[16] broadly understood as referring to the risk of economic instability becoming so widespread to impair the functioning of whole economic sector or sub-sectors,[17] this type of 'fragility'

[15] For a new vision and awareness of systemic risks in a post-Covid World, see, *inter alia*, World Economic Forum, *The Global Risks Report 2021* (2021) 16th Edition Insight Report, es.weforum.org/reports/the-global-risks-report-2021.
[16] Systemic risk is not limited to credit institutions (banks) and is also a critical factor within the functioning of the other sub-sector of the financial system. However, the high level of interdependence between banks, which represents a distinctive trait of the banking sub-sector, especially enhances systemic risk as regards this particular sub-sector of the financial system. See on this particular relevance of systemic risk for banks, Chryssa Papathanassiou and Georgios Zagouras, 'A European Framework for Macro-Prudential Oversight' in Eddy Wymeersch, Klaus J. Hopt, and Guido Ferrarini (eds), *Financial Regulation and Supervision – A Post-Crisis Analysis* (OUP 2012).
[17] See on these and related notions of *systemic crisis*, ECB, *Financial Stability Review* (December 2009) IV.B 134, ecb.europa.eu/pub/pdf/fsr/financialstabilityreview200912en.pdf; Olivier de Bandt and Philipp Hartmann, 'Systemic risk: A survey' (November 2000) ECB Working Paper Series No 35, ecb.europa.eu/pub/pdf/scpwps/ecbwp035.pdf.

– acutely acknowledged in the last financial crisis - is not necessarily limited to banks and the financial system.[18]

The current crisis, with its (aforementioned) combined demand-side and supply-side shocks is a paradigmatic illustration of *systemic risks* working powerfully outside the banking or financial sector to which little attention has been paid over the last decade (and which, conversely, justifies considerable critical focus for the near future, after the most acute phase of the COVID-19 crisis ends, both as regards risks associated with health and other types of factors or accidents with a potential spill over effect). If we consider the three key manifestations or dimensions of *systemic risk*, comprehending *contagion risk*, risks of *macro shocks originating simultaneous problems*, and risks of the *unravelling of balances that have built over time*,[19] the first and second dimensions seem to be playing a large part in the successive shock waves of the COVID-19 economic crisis. The exogenous COVID-19 shock is undoubtedly producing high levels of *contagion risk*, quickly materialising in a context of highly complex and interdependent supply-chains, relying on a vast gamut of inputs (originating in a significant part from South-East Asia and China). This is particularly visible in sectors like electronic communications

[18] On the notion and the new post-crisis conceptual awareness of systemic risks see, within the extensive specialised literature dedicated to this topic, Eilis Ferran and Kern Alexander, 'Can Soft Law Bodies be Effective? Soft Systemic Risk Oversight Bodies and the Special Case of the European Systemic Risk Board' (2011) University of Cambridge Faculty of Law Research Paper No 36/2011 6.

[19] On these manifestations or dimensions of *systemic risk*, see, *inter alia*, Jon Danielsson et al., 'Modelling financial turmoil through endogenous risk' (*VoxEU CEPR*, 11 March 2009), voxeu.org/article/modelling-financial-turmoil-through-endogenous-risk; Jon Danielsson, *Global Financial Systems – Stability and Risk* (Harlow: Pearson 2013).

and digital technologies, but by no means limited to these as a growing number of economic sectors is relying more heavily in interconnected networks with great geographic dispersion.

Furthermore, the second aforementioned dimension of *macro shocks originating simultaneous problems* is also heavily at play now due to the combination of simultaneous demand side and supply side problems arising from the public health macro-shock.

As such, a proper assessment of the *systemic risks* forces operating in this crisis – *outside the financial system* – will definitely involve new analytical tools oriented towards the collection and comprehensive evaluation of data on firm-level networks[20] (which, in time and depending on the now unforeseeable duration and extension of the crisis even after the initial successes of the vaccination programs in the US and the EU, may lead to a global overhaul and re-thinking of the prevailing models of firm-level networks in order to mitigate the factors of systemic risk).

1.2.3. It may therefore be assumed as almost consensual that there are no forces of *systemic risk* inherent to the financial sector (or the banking sub-sector) fuelling the current COVID-19 crisis. In other words, considering the characterization of *financial risks* put forward by Danielsson and Shin, as *endogenous* and *exogenous risks*,[21] the COVID-19 shock is absolutely *exogenous*. However, this does not mean that a

[20] See on this, Jonathan William Welburn et al., 'Systemic Risk: It's Not Just in the Financial Sector' (2020) RAND Corporation Research Briefs, rand.org/pubs/research_briefs/RB10112.html.
[21] See on this characterization and distinction, Jon Danielsson and Hyun Song Shin, 'Endogenous risk' in *Modern Risk Management —A History* (Risk Books 2002), riskresearch.org/papers/DanielssonShin2002.

potential for *endogenous risk amplification* could not come to exist within the financial sector (and particularly the banking sub-sector), although the trigger is, at the start, an exogenous shock.[22] In a nutshell, and to put it in simpler terms, it is of paramount importance to prevent too prolonged and intense exogenous risks – originating in the rest of the economy - affecting the banking sector, that *could generate some form of uncontrolled amplification within the banking sector* and – in a second stage – produce what would come to represent a true *systemic financial crisis* also building on remaining vulnerabilities of the banking sector (especially in the EU, compared with a much more positive picture in the US, in spite of the significant and undeniable progress arising from regulatory reform and the building of the Banking Union and related instruments).

Accordingly, it is vital that a timely mix of monetary and financial policy measures at EU level (as briefly discussed *infra*, in sections **2.** and **3.**) properly ensure a limited duration and intensity of the exogenous risks arising from the recession in various economic sectors and, at the same time, that no major conditions for *amplification* of these adverse effects occur in the banking sector, through a most careful calibration of the supervisory flexibility applied to banks (and somehow intended to ease the pressure on the rest of the economy) – as briefly discussed *infra*, in section **4.** (and at least partially ensured in the EU after the first quarter of 2020, thanks largely to the reforms of the previous decade).

[22] See on these possibilities, Jon Danielsson et al., 'The coronavirus crisis is no 2008' (*VoxEU CEPR*, 26 March 2020), voxeu.org/article/coronavirus-crisis-no-2008.

Conversely, if those twofold conditions are met, the banking sector is almost ideally placed to make a fundamental contribution to the economy and citizens in general. In fact, as duly emphasized by Mario Draghi, '*banks* (…) *extend across the entire economy and can create money instantly by allowing overdrafts or opening credit facilities*'.[23] Through that contribution banks would be diluting the adverse image arising from the kind of negative management culture that has been perceived by society in general from the last crisis.[24] Also, if in this process, the banking sector intensifies its adaptation to new operational conditions, within the digital environment fostered by the crisis, the current turmoil may ultimately generate interesting opportunities for an overall positive transformation of banking.

At this stage, after a critical period which lasted for a significant part of 2020 in which it has been difficult to predict how the pendulum would swing between, on the one hand, the **momentous risks at stake**, and, on the other hand, the **positive opportunities** lying ahead of the banking sector, it may be assumed that the second scenario may largely prevail. This more positive scenario, due both to the concerted and intensive regulatory short-term response at EU level (building on the institutional architecture supporting, however incompletely, a *stabilization function* after the last crisis) and, in no shorter part, to the game-changing quick introduction of COVID-19 vaccines, does not mean that the risks are completely overcome

[23] See Draghi (n 13).
[24] See on this perspective, Group of Thirty, 'Banking conduct and culture: A permanent mindset change' (November 2018), group30.org/images/uploads/publications/G30_Culture2018_FNL3lo-compr essed.pdf (emphasizing that '*most banks should aim for a fundamental shift in the overall mindset and culture'*).

nor, more decisively, that the EU and its banking sector are in a position to fully use the opportunities ahead to fuel a solid and not too asymmetric economic recovery (and one which does aggravate economic and financial fragmentation between various regions of the EU).

2. The EU response to the crisis within the constraints of an unfinished EMU: has the transformation of key policy principles of EMU gone far enough and how far need we go?

2.1. Introductory remark and overview of analytical framework

2.1.1. Considering the abrupt irruption of the COVID-19 economic shock and crisis almost immediately in the wake of the completion of two decades of EMU, Mario Draghi sounded, again, almost prophetic when he stated, in his farewell speech as ECB President, that the two decades of monetary union, beside a momentous anniversary, corresponded more to an occasion to reflect than to celebrate.[25] I would daresay that was a moment to acknowledge the degree of undeniable success of the project – evidenced by its survival over the previous economic shock - but also to assess its limitations or, above all, its persisting risks and how to overcome such risks,[26] especially when these are subject, once more and sooner than was

[25] See Mario Draghi, 'Farewell Remarks' (Frankfurt am Main, 28 October 2019), ecb.europa.eu/press/key/date/2019/html/ecb.sp191028~7e8b444d6f.en.html.

[26] See on this analysis and balance, in which this part of the present article also relies, Luís Silva Morais, 'The structuring principles of the Economic and Monetary Union', in *Banco de Portugal – Report of the Conference: The Euro 20 years on* 55, bportugal.pt/sites/default/files/anexos/pdf-boletim/reportconference20yearseuro.pdf.

expected, to the harsh reality test of another major crisis, also with a potentially systemic component (albeit different in nature, as already observed, from the previous crisis).

As regards a desirable critical overall reflection on the Project of the Euro, Mario Draghi has underlined, in that farewell speech, two vital lessons for a successful EMU arising from the past twenty years, which provide us with a good analytical roadmap to test its ability to resist the new COVID-19 economic crisis and a way-out to that crisis: The first lesson concerns monetary policy and the way that policy may be called to face deflationary forces, requiring, as such, *flexibility in the toolbox of instruments to fulfil the mandate of ECB*, albeit '*without ever exceeding the limits of the law*',[27] although I would venture to add, at the same time, *testing in a very demanding manner the very limits and flexibility of the law*.

The second lesson underlined by Mario Draghi concerns the *institutional construction of EMU* and justifies an overall critical reflection about the complex institutional fabric of EMU. That in turn implies two consecutive steps. First, to take stock of where we are now and where we may be heading in light of recent developments, in the post GFC years, that largely coincide with the last decade. Furthermore, as a second step, it implies ascertaining the ability of this institutional structure to withstand a new shock of a different nature, as the COVID-19 shock, and to ensure a consistent and not entirely asymmetric

[27] Quoting here literally from Draghi (n 25), although the legal debate is far from being closed and may, on the contrary, have entered in a new critical stage.

recovery, which would be bound to aggravate the political, social, and economic tensions underlying EU integration.[28]

2.1.2. Against this background, this Chapter purports, taking a wider approach, to focus in this second lesson arising from the past twenty years, highlighted by Mario Draghi, and concerning a set of core issues related with the *institutional construction of EMU*. With that purpose in mind, I shall try to offer an *overall picture of the* ***key policy principles of EMU***, as designed in the Maastricht Treaty[29] and in the first steps of implementation of the EMU project. Starting from that brief exercise I purport to critically ascertain the *evolution* of such *policy principles* and, above all, **the extent to which *that evolution*** – as occurred so far, and as to be pursued in the near future in the context of the legal and economic dynamics of integration arising from the Euro project and its new pressing challenges **- may represent (*or not*) a true qualitative transformation or *metamorphosis of the Euro project*** (ensuring, or not, in turn, its resilience to the new exogenous shocks as the one represented by the COVID-19 crisis).

Focusing on this institutional perspective of EMU, I would recall an expression coined by one of the founding fathers of

[28] See Debora Revoltella and Rolf Strauch, 'Jump-starting investment for a strong and even recovery: A call for more equity finance for EU firms' https://voxeu.org/(VoxEU CEPR, 24 May 2021), voxeu.org/article/jump-starting-investment-strong-and-even-recovery ('The asymmetric sectoral crisis also suggests a risk of intra-EU divergence in the recovery, with an uneven distribution of more endangered sectors in the total value added of member states').

[29] See Jean-Victor Louis, 'A Monetary Union for Tomorrow?' (1989) 26 Capital Markets Law Review 301, 302 (on the key parameters guiding the negotiation of contours of EMU in the course of the normative and institutional developments that led to the Maastricht Treaty).

such Union, Padoa-Schioppa, who suggestively referred to the risk of an '*institutional loneliness*' of the ECB.[30] And, in fact, the initial construction of EMU underestimated – but it was the historical context at the time - the powerful forces of *financial integration* unleashed by the monetary union and the risks these entailed under the impact of a strong international shock originating a banking crisis evolving towards a sovereign debt crisis. Accordingly, the initial institutional fabric of EMU did not contemplate a **true dimension of *fiscal stabilization*** involving, as such, at least to a certain extent, some elements of fiscal union (the intensity or contours of which have still to be determined).

It is therefore most pertinent in the current context to briefly cover some key aspects of this ***institutional transformation of EMU*** oriented towards overcoming the gap in the fiscal stabilization function, and the challenges such transformation has endured in the judicial arena, referring here to current and prospective case law of the European Court of Justice (ECJ) and of the German Constitutional Court ('*Bundesvertassungsgericht*'), including in this latter case the most recent 2021 developments involving the 'EU own resources' decision (considering, as well, beside this judicial scrutiny, other challenges in terms of democratic legitimacy of the whole process).

I shall also very briefly dwell on the new building blocks of European financial integration related with monetary union, especially the *European Banking Union* (and to a lesser extent the *European Capital Markets Union*), bearing in mind their

[30] See, on this Tommaso Padoa-Schioppa, *The Road to Monetary and Economic Union in Europe: The Emperor, the Kings and the Genies* (OUP 1999).

contribution to prevent or invert the trends towards financial fragmentation arising from the sovereign debt crises and their potential role in preventing or, at least, containing economic and financial instability arising from the current COVID-19 shock.

2.2. Introductory remark and overview of analytical framework

2.2.1. As a first step we should then try to identify the principles underlying the initial EMU project and the way these evolved or, if the case may be, were transformed, either through extensive interpretation, or through complementary normative steps, gradually fulfilling the initial gaps of the institutional construction of EMU.

The original EMU was effectively based on a set of core '***policy principles***'. And I shall refer here to '*policy principles*' in a wider sense than *strict legal principles*, deriving such principles from statutory law, but also from policy statements and consistent practices of key institutional actors (following a 'law in action' perspective).

In a nutshell, and being almost telegraphic (*brevitatis causae*) in the identification and characterization of such *policy principles*, reference should be made here to two core principles:

- Firstly, in the monetary field we may consider a principle of ***separation between monetary and fiscal authorities*** within a ***single or core objective of price stability***, determining that the ECB conducts monetary policy of the EU in accordance with 127(1) of the TFEU (Treaty on the Functioning of the European Union), thereby maintaining price stability as its primary objective. Furthermore, to the extent that the objective of price stability is not undermined, the ECB shall also support the general economic policies in the Union as its secondary objective;

- Secondly, in the *fiscal and the financial regulation and supervision areas* (*lato sensu*) there were mere EU level directives or parameters of fiscal discipline, including a *prohibition or limitation of cross-national allocation of resources and risks*, enshrined in the much discussed and somehow hastily designated '*no bail out clause*' of Article 125 of the TFEU, and an initial focus on micro-prudential regulation (Basel II style). And, so, basically, in this field, the key *policy principle* was a ***marked distinction or separation* between *monetary authority at central level* and *financial supervisory authorities*** (especially the *banking supervisory* pillar) ***at national level***, although subject to coordination.

2.2.2. Only this type of separation in the context of the initial *policy principles* of EMU can explain, given the key importance of the banking sector and of the mechanisms of monetary transmission related to it, the *truly striking near absence of rules in the TFEU on banks and the banking sector* (aside from Articles 127, 5 and 6). This contributed, indeed, to fundamental imbalances when the mechanisms of monetary transmission, *involving banks*, were seriously disrupted in 2008 and afterwards. It also contributed to the serious omissions in addressing core matters of *financial stability* within EMU in connection with the *pivotal position of the banking sector to* *that overall financial stability*.[31] Considering the overall *political* importance of banks and of the banking system, which should be acknowledged as such, the lack of provisions addressing the vital role of banks in the *political and institutional* contours and functioning of a non-dysfunctional EMU represented actually a major imbalance of the initial design of EMU in the European Treaties. In fact, the lack of a consistent economic and budgetary pillar of EMU is, at this stage, frequently singled out as a major factor for the EMU imbalances, but this ***lack of normative focus on the role of the banking system***, to my mind, has played no minor part in those imbalances (and has been too frequently overlooked). This omission is also particular serious – as briefly touched *infra*, **4.** – in a context in which a post COVID-recovery strategy would require, as proposed in some recent analyses, some sort of a '*New Deal'* for the EU banking sector,[32] or, as I prefer to call it, a *new overall EU strategic policy for the banking sector*.

Starting from this key acknowledgment, it manifestly exceeds the limited purview of this Article to dwell in detail with the

[31] See on this, *inter alia*, Pierre Schlosser, *Resisting a European Fiscal Union: The Centralized Fragmentation of Fiscal Powers During the Euro Crisis* (European University Institute, PhD Dissertation, 20 December 2016); Dirk Schoenmaker, 'A Fiscal Backstop to the Banking System' in Matthias Haentjens and Bob Wessels (eds), *Research Handbook on Crisis Management in the Banking Sector* (Edward Elgar Publishing 2015); Gabriel Gloeckner et al., 'Explaining the Sudden Creation of a Banking Supervisor for the Euro Area' (2017) 24(8) Journal of European Public Policy 1135-1153.

[32] See on this concept, to which I shall briefly return, *infra*, 4., Peter Nathanial and Ludo Van-der-Hayden, 'EU Banking in the Covid-19 Crisis: Time for a 'New Deal'' (14 May 2020) INSEAD Working Paper No 2020/25/Fin/TOM, papers.ssrn.com/sol3/papers.cfm?abstract_id=3610653.

building of the European Banking Union in the context of the *asymmetries* I have been referring as regards the original EMU.

Suffice is to state that given the two initial policy principles I have been systematically referring of separation between the monetary domain and both the fiscal and financial supervisory areas lato sensu, there were no EU institutions or instruments in place to deal with risks and vulnerabilities either originated (as in the last crisis) or largely amplified (as it may happen in the current crisis) by the financial sector. There were neither common instruments in case a sovereign faced a liquidity or solvency crunch nor even common instruments for the surveillance of risk for banks or for their liquidity or solvency crises.

The Banking Union was a partial response to those imbalances, while in itself incomplete up to now, with its pillars comprehending a single rule book for banks, a Single Supervisory Mechanism (SSM) (within the ECB), a single resolution mechanism (SRM) – intended to ensure an orderly way-out for problematic banks (still in progress and imperfect or incomplete in various aspects) - and a much debated European deposit insurance system[33] (still not launched and

[33] It exceeds again the very limited purview of this paper to characterize and discuss these pillars of the European Banking Union. See on this, *inter alia*, Rosa M. Lastra, 'Banking Union and Single Market: Conflict or Companionship?' (2013) 36 Fordham International Law Journal 1190; Jens-Hinrich Binder, 'The European Banking Union: Rationale and Key Policy Issues' in Jens-Hinrich Binder and Christos V. Gortsos (eds), *Banking Union: A Compendium* (Nomos 2016), ssrn.com/abstract=2597676; Niamh Moloney, 'European Banking Union: Assessing its Risks and Resilience' (2014) 51 Common Market Law Review 1609; Daniel Gros and Dirk Schoenmaker, 'European Deposit Insurance and Resolution in the Banking Union' (2014) 52(3) Journal of Common Market Studies 529-546.

about which the political debated has been relaunched, notably by Germany, in the last quarter of 2019[34]).

2.2.3. On the whole, and again without time to enter into the details, the initial too rigid **separation** between the **monetary domain** and both the **fiscal and financial supervisory areas** has been gradually – however imperfectly – addressed, bearing in mind macro-prudential policies and concerns and the acknowledgement of a much needed ***financial stabilization function*** centred in a new *euro-crisis management framework* for which *liquidity instruments of assistance* are of the essence. The problem is that, despite *institutional building* in this domain, *those functions are rather incoherently dispersed between various EU actors, including the ECB, the European Stability Mechanism, or the Single Resolution Board (and the Single Resolution Fund).*

In this context, I would also venture to add, closing the circle, that macro-prudential policies and concerns and, above all, the acknowledgement of the need of an ***overall financial stabilization function*** are also underlying the building of *non-standard measures* of ECB in the monetary field – and, as such, these do not represent mere *ad hoc* measures or some form of legal and economic '*bricolage'*, but, somehow, the **beginning of a fundamental change in the design of EMU.**

[34] I refer here to the position presented by the German Finance Minister, Olaf Scholz, to unlock the European Deposit Insurance Scheme (EDIS) proposal (which will not be not commented here for lack of time). See Olaf Scholz, 'Position Paper on the Goals of the Banking Union' (November 2019) Bundesfinanzministerium non-paper; Luis Garicano, 'Two proposals to resurrect the Banking Union: The Safe Portfolio Approach and SRB+' (*VoxEU CEPR*, 17 December 2020), voxeu.org/article/two-proposals-resurrect-banking-union-safe-portfolio-approach-and-srb.

2.2.4. Keeping the extremely succinct nature of this analysis, as aforementioned, I purport at this point to reach some tentative conclusions, coming back to the ***two initial policy principles of EMU*** I have underlined at the beginning (*infra*, **2.2.1.**), and trying to put into perspective their evolution and transformation.

As regards the **separation of monetary and fiscal/financial authorities**, pressing requirements of **financial stability** have led to a new interplay between those domains and to, I would daresay, a **reinterpretation of the *key monetary policy goal of price stability***, based on its *extensive reading*.
This development and this extensive reading have been challenged in Courts, especially at the German Constitutional Court, leading to fundamental rulings of the ECJ, namely the '*Gauweiler'* ruling (on the OMT program of the ECB)[35] and the December 2018 '*Weiss'* ruling on the ECB Public Sector Purchasing Program (PSPP) (*which, differently from OMT program, has actually been implemented*).[36]

Again, the very limited purview of this analysis does not allow me here to go into the details of this last ruling but one passage of it deserves quoting. I refer here to paragraph 60 of the '*Weiss'* ruling, where the ECJ states unequivocally, referring to Articles 127, 119, 130 TFEU, that (direct quote) '*the authors of the Treaties did not intend to make an absolute separation between economic and monetary policies* (…).'

It can be anticipated, at this stage, however, that the ECJ '*Weiss*' ruling will not be the last chapter in this string of judicial challenges in particular due to the stance and judicial activism of the *Bundesvertassungsgericht* (German Constitutional

[35] See Case C-62/14 *Peter Gauweiler and Others v Deutscher Bundestag* [2015].
[36] See Case C-493/17 *Heinrich Weiss and Others* [2018].

Court). In fact, not only by the last quarter of 2019 a group of German academics has tried (unsuccessfully) to reopen Hearings in the case, concerning the ECB *Public Sector Purchasing Program* (PSPP), due to the then adopted ECB decision of resuming bond purchases for an indefinite period as from 1 November 2019[37], as - more decisively - the *Bundesvertassungsgericht* finally delivered its 5 May 2020 judgement on PSPP, which, although rejecting the plaintiffs' claims that PSPP violated the EU ban on monetary financing of governments, casted some remaining clouds of doubts and legal uncertainty, by ruling that the ECB had not adequately applied a *proportionality test* to such Program (and giving the ECB three months to justify its bond-buying).

Again, it manifestly exceeds the limited purview of this text to critically analyse this 5 May 2020 judgement of the *Bundesvertassungsgericht* -[38] to which, nevertheless, I shall briefly come back (*infra*, **2.3.**) pondering its potential repercussions on the *Pandemic Equity Purchase Program* of the ECB (PEPP) in connection with the COVID-19 pandemic. For the moment, suffice is to add that this judgement will not close the string of judicial controversies in this most sensitive domain.

2.2.5. As regards the other initial policy principle of EMU previously referred, of a distinction or separation between central or supranational monetary policy and financial supervision (and related functions) essentially developed at

[37] See BVerfG, 'Oral hearing in the proceedings 'Expanded Asset Purchase Programme of the European Central Bank' on Tuesday, 30 July 2019, 3:00 p.m., and Wednesday, 31 July 2019, 10:00 a.m.' Press Release No 43/2019 (25 June 2019), bundesverfassungsgericht.de/SharedDocs/Pressemitteilungen/EN/2019/bvg19-043.html.
[38] BVerfG, 2 BvR 859/15 - paras. (1-237).

national level, such distinction has been blurred with a movement towards the supranational level, which will be of paramount importance to ensure an adequate response to the COVID-19 crisis in terms of a proper safeguard of financial stability.

In this case, differently from what happened with the principle of **separation of monetary and fiscal/financial authorities**, and the reinterpretation of the *key monetary policy goal of price stability* (albeit subject to legal challenges, as drastically recalled by the 5 May 2020 Judgement of the *Bundesvertassungsgericht*), the new developments were not chiefly produced through extensive interpretation of legal goals, but through normative developments (which leaves us in more solid ground). I refer here to new normative developments to the extent these have been allowed without Treaty Change, somehow overcoming the traditional *Meroni* doctrine[39] or using, to the fullest extent possible, the normative bases consented by the Treaties, *e.g., as regards the possibility originally envisaged to attribute prudential banking supervision functions to the ECB* or the possibility of new international Treaties that do not conflict as such with the EMU provisions of the TFEU, as envisaged in the *Pringle* jurisprudence of the ECJ.[40]

Referring to this Pringle jurisprudence it is worth emphasizing here the extent to which some **fundamental changes of the**

[39] See on the overall reach and corollaries of the *Meroni Doctrine*, Edoardo Chiti and Pedro Gustavo Teixeira, 'The Constitutional Implications of the European Responses to the Financial and Public Debt Crisis' (2013) 50 Common Market Law Review 683.

[40] Case C-370/12 *Thomas Pringle v Government of Ireland and Others* ECLI:EU:C:2012:756.

qualitative nature and structure of EMU have actually been possible outside a formal overall Treaty change procedure.

In theory, the Treaties set the limits for secondary law such as the so called 'Six-Pack'1 or the 'Two-Pack'2 regulations.[41] However, in my view, the ***normative building blocks of an evolving architecture of EMU*** *have diversified, as room was opened to international treaties concluded by a subset of*

[41] More specifically, I am referring here, to the *EU six-pack* relating to the following regulations and guidelines: On fiscal policy, Regulation (EU) 1175/2011 of the European Parliament and of the Council of 16 November 2011 amending Council Regulation (EC) 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies [2011] OJ L 306/12; Council Regulation (EU) 1177/2011 of 8 November 2011 amending Regulation (EC) 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure [2011] OJ L 306/33; Regulation (EU) 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area [2011] OJ L 306/1; Council Directive 2011/85/EU of November 2011 on requirements for budgetary frameworks of the Member States [2011] OJ L 306/41; Regulation (EU) 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances [2011] OJ L 306/25 (laying out the details of the macroeconomic imbalance surveillance procedure and covers all EU member states); Regulation (EU) 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement action to correct excessive macroeconomic imbalances in the euro area [2011] OJ L 306/8 (only applying towards all Eurozone Member States, and focusing on the possibility of sanctions and other procedures for enforcement of the needed 'corrective action plan', to satisfy the EIP recommendation from the Council.
And to the *EU two-pack regulations* relating to the following Regulations: Regulation (EU) 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area [2013] OJ L 140/11; Regulation (EU) 472/2013 of the European Parliament and of the Council of 21 May 2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability [2013] OJ L 140/1.

Member States, such as the *Treaty on Stability, Coordination and Governance in Economic and Monetary Union* (TSCG) and, *more importantly*, the *Treaty establishing the European Stability Mechanism* (ESM-Treaty).

Fundamentally, the ECJ paved the way in this direction with its '*Pringle*' ruling on the compatibility of the ESM-Treaty with EU law when it concluded that the ESM-Treaty – establishing a form of financial assistance for Eurozone members having economic difficulties - could enter into force, even before the formal introduction of a third paragraph of Article 136 into the TFEU, stating that the Eurozone Member States might establish a stability mechanism.

In the *Pringle* case, effectively the ECJ accepted there might be an **overlap** between_**economic** and **monetary policies** and started to abandon the **initial policy principle** I referred before, of **strict separation between such domains** apparently flowing forth from the Treaties. This *Pringle* precedent was noteworthy and ground-breaking through its reading of the so-called no-bail-out clause of Article 125 of TFEU. To some extent the ECJ resorted to a legal technicality (not exempt of controversy but effectively sorting out a substantive deadlock in terms of interplay between economic and monetary policies), emphasizing a rather literal reading of Article 125, which signalled that the ESM would grant *loans to countries* instead of directly *assuming the debts of those countries* (also underlining that ESM loans were to be accompanied by *conditionality* and were to contribute to the *overall stability of the Euro area*, which ultimately provided the original basis for introducing the no-bail-out clause in the Maastricht Treaty, with the ECJ thus closing here the circle and combining a literal with also a *substantive, finalistic, reading of the relevant provisions* *of the TFEU*).[42] This new approach and its wider corollaries in terms of **interplay between economic and monetary policies** will prove of decisive importance to equip a **transformed EMU** with legal and institutional ground and leeway to frame a response to the COVID-19 economic crisis, and build a path to economic recovery post-COVID, involving *multiple elements of financial assistance to Member-States* (particularly in the Euro area), as very briefly envisaged *infra*, section **3**.

2.2.6. Coming back to the decisive transformation of the second initial policy principle of EMU of distinction or separation between central monetary policy and financial supervision (lato sensu) essentially developed at national level, the key problems here are not so much judicial challenges, as it has been happening with non-conventional monetary policy measures, although there exist also relevant judicial developments in Germany concerning the transfer of supervisory tasks to the supranational level,[43] but how to address issues of democratic legitimacy and accountability of the new institutional building of the Banking Union (and related developments) and how to complete the missing pieces of said the Banking Union.

These developments imply the transfer to the EU of *banking supervision and resolution competences* which were before close to the core of *national fiscal sovereignty* and subject, as such, to high standards of democratic accountability. **In order to ensure full use of these competences at EU level**, through

[42] See on this, *inter alia*, Bruno De Witte and Thomas Beukers, 'The Court of Justice Approves the Creation of the European Stability Mechanism Outside the EU Legal Order: Pringle' (2013) 50(3) Capital Markets Law Review 805.
[43] Notably with BVerfG, 2 BvR 1685/14 - 2 BvR 2631/14, on the transfer of supervisory tasks to the ECB/SSM, which will not be specifically covered here.

timely, comprehensive and coherent responses to the current economic shock, monitoring and comparing instantly the soundness of banks and, at the same time, allowing some degree of supervisory flexibility (alleviating capital buffers, as determined by the SSM still in the first half of March), having the necessary awareness of liquidity concerns in the banking sector, and acting accordingly to prevent the materialization of liquidity risks, **high levels of democratic accountability of the new EU financial supervisory architecture are of paramount importance** (and do not represent mere formal concern).[44]

2.3. Policy principles of EMU effectively transformed ex post and European response to COVID-19 crisis

Having replied positively to the structural question identified as the starting point and axis of this analysis, and having assumed thereby that *the two defining policy principles which provided the initial launch pin of EMU and its governance have been effectively transformed ex post in the course of the last decade*, it remains to be seen if the extent of such transformation is sufficient to accommodate a new and extreme economic shock, as the one arising from COVID-19. The answer is however uneven. In terms of monetary policy, the response seems overwhelmingly positive.

Actually, the reinterpretation of the *key monetary policy goal of price stability* commented in the preceding sections has allowed the ECB, after an initial misstep, to react swiftly to the COVID-

[44] See on the key issues of democratic accountability of the new EU financial supervisory architecture, Pedro Gustavo Teixeira, 'The democratic legitimacy of the Banking Union', in *The Legal history of the European Banking Union* (Hart Publishing 2020).

19 shock through a temporary program to purchase up to 750 billion Euros in public and private-sector securities - a program then successively increased by 600 billion Euros on 4 June 2020 and by 500 billion Euros on 10 December 2020, for a new total of 1,850 billion Euros - until the ‘crisis phase’ of the COVID-19 pandemic is over, but, in any case not before the end of March 2022.

The *Pandemic Emergency Purchase Programme* (PEPP) represents, therefore, a logic expansion of the ECB’s Asset Purchase Programme (APP) - the package of asset-purchase measures that the ECB initiated in 2014 to support monetary policy (or a *reinterpretation of such policy*, as previously discussed). The PEPP, like the earlier APP, includes programs to buy sovereign debt, covered bonds, asset-backed securities, corporate bonds, and commercial paper. Flexibility seems to be a key component of the development of the Program as the ECB removed the limit to buy no more than 33% of any country’s bonds, initially announced, and is investing itself with the authority to essentially purchase unlimited amounts of sovereign debt, up to the €750 billion limit, emphasizing that it would *not tolerate any risks to the smooth transmission of its monetary policy in all jurisdictions of the Euro area* (and making somehow clear that, although a wide range of securities are eligible for purchase under PEPP, the vast majority of securities to be purchased will be government debt).[45]

[45] See in general as regards the *Pandemic Emergency Purchase Programme* (PEPP), Decision (EU) 2020/440 of the ECB of 24 March 2020 on a temporary pandemic emergency purchase programme ECB/2020/17 [2020] OJ L 91/1 and related ECB statements. See on further developments EBI, ‘EBI Report on the ‘Pandemic Crisis-related’ Economic Policy and Financial Regulation Measures: International, EU Area Levels’ (18 December 2020)

In spite of this apparent positive reply of monetary policy, the aforementioned judgement of 5 May 2020 of the *Bundesvertassungsgericht* has introduced a cloud of legal uncertainty, when it ruled that the ECB did not properly applied a 'proportionality' test to the PSPP accounting for its economic side-effects.

Although the *Bundesvertassungsgericht* rejected the plaintiffs' claims that the ECB actions had violated the EU ban on monetary financing of governments and gave the ECB three months to justify its bond-buying, an appreciable level of legal uncertainty has, nonetheless, be unavoidable (although overcome in this specific case due to the compromise approach followed with considerable leeway towards a possible *ex post* justification). In fact, the time limit specified by the *Bundesvertassungsgericht* for the ECB to further justify its programme, without which the *Bundesbank* should cease its participation in the PSPP, expired on 5 August 2020, without visible consequences. That was essentially due to the fact that additional information was in the meantime provided by the ECB and the *Bundesbank*, with a German Federal Parliament voting, on 2 July 2020, to back the ECB program, expressly recognizing '*the ECB's proportionality check as comprehensive*', thus fulfilling the conditions laid down by the previous Court ruling and, in turn, paving the way, for the *Bundesbank*, to continue its asset purchase operations under the PSPP beyond the 5 August 2020 deadline.

Ultimately, the compromise formulation adopted by the *Bundesvertassungsgericht* and the corresponding compromise approach adopted by the ECB have successfully diffused the

EBI Report, ebi-europa.eu/wp-content/uploads/ 2020/12/EBI-Covid-Report-32-as-of-18.12.2020.pdf.

tension and contributed for the moment, in rather pragmatic terms, to overcome the initial apparent hurdles confronting PSPP, but a fundamental legal problem still persists here (although, at the same time, a normative window for justification of these programs has been opened). In fact, this will almost certainly not be the end of the story of the decade's old disagreements between the *Bundesvertassungsgericht* and the ECJ. Sooner or later, it will very likely emerge again (with the aggravating factor that even the authority of the ECJ itself, as the supreme interpreter of Union law, has been questioned, thus raising a key legal debate which we do not have room to further pursue here).[46]

Actually, while the ECB has decided to comply with the judgement requirements and produced complementary justification of its actions in this domain, and even though it has pragmatically accomplished this in a simpler form through disclosure of some complementary economic documentation supporting PSPP, there can be an inherent element of contradiction between such justification and the actual economic effects at stake, particularly the type of economic effects intended through a *relaxation of usual criteria of bond-buying* in the particular conditions of the new PEPP (although PEPP is not at stake as such in the 5 May Judgement). It will be therefore of vital importance to dispel the risks of legal uncertainty that have now arisen and to create the conditions for

[46] Se on this wider legal debate, *inter alia*, Joseph H H Weiler and Daniel Sarmiento, 'The EU Judiciary After Weiss - Proposing a New Mixed Chamber of the Court of Justice' (*Verfassungsblog*, 2 June 2020); José Luís Cruz Vilaça, 'Can the EU avoid further clashes with the German Constitutional Court?' (*Euroactiv*, 24 August 2020); Isabel Feichtner, 'The German Constitutional Court's PSPP Judgment: Impediments and Impetus for the Democratization of Europe' (2020) 21(5) German Law Journal 1090-1103.

a consolidation of the previous '*Weiss'* jurisprudence, duly asserting, in the process, the ECJ as the only legal body able to determine if an EU institution violated EU law. As we shall observe (*infra*, **3.**), the new 2021 *Bundesvertassungsgericht* case on the legality of the German ratification of the regime which allows financing of the EU Next Generation recovery fund, through bond issues of up to 750 billion Euros, evidence that in this sensitive domain of the normative basis and boundaries of a potential '*financial union'* a cloud of legal uncertainty is for the moment bound to persist.

At another level, our second positive reply to the core question delineated as the initial *leit motif* of this article, concerning the **transformation *ex post* of the founding policy principles of EMU -** that has led us to identify the *emergence of a* ***new EU architecture of EU financial supervisions*** *(albeit incomplete) oriented towards the fulfilment of a* ***function of financial stability*** (especially in the eurozone) **-** enhances the conditions for a contribution of the banking sector in the EU response to the crisis, at a level compatible with the economic and political importance of this sector in a crisis of this dimension (it remains, however, to be seen if that promise duly materialises, as briefly discussed *infra*, section **4.**).

3. EU fiscal response to COVID-19 crisis and the stimulus to economic recovery: can it follow the monetary pillar?

3.1. Overall perspective

If monetary policy, as reinterpreted in the wake of the last crises, seems to have provided an effective response at the level of EMU to the COVID-19 shock (notwithstanding the elements of relative uncertainty brought about by the aforementioned

Bundesvertassungsgericht judgment), the same cannot be assumed as regards the fiscal pillar of EMU, although a significant progress has been achieved in this domain during the second semester of 2020.

Ideally, within the transformation of the governance and overall structures of EMU (characterized *supra*, **2.**) we should expect a positive interplay and even coordination of monetary policy actions, banking supervisory measures (given the key role of banks in supporting the economy at this critical stage) and a consistent and coherent *package of fiscal measures* to support the EU member States economies in the transition to the recovery.

However, to a large extent, this latter component has still depended predominantly, at least during an initial stage of the crisis, on interventions - made possible by a swift and unprecedented activation of the general escape clause of the Growth and Stability Pact -[47] from *national fiscal authorities* (with widely varying fiscal capacity and starting from an extremely diverse basis as regards ability to issue national debt to support such fiscal efforts). If, due to these constraints, a decisive gap would ultimately materialise as regards the fiscal effort between the various Member States, new powerful forces would emerge towards fragmentation and segmentation of the banking sector along national lines and the consequences would be twofold, translating both **(i)** into reduced capacity of fragmented banking sectors to support the economy and **(ii)** into

[47] See EC, 'Communication from the Commission to the Council on the activation of the general escape clause of the Stability and Growth Pact' (Communication, 20 March 2020) COM/2020/123 final.

potential imbalances of banks as well (along those national lines).

So, it is of vital importance that the ***transformation of key policy principles of EMU*** over the course of the last decade – as envisaged in the first part of this article - also materialises in some forms of *joint fiscal effort* (duly combining the monetary and fiscal pillars).

Here we believe the solution should lie in a *mixed approach*, combining different fiscal instruments (and multiple institutional levels), a short and medium-term perspective, and not entering into a protracted legal and political debate on sort of a '*big bang*' fiscal response.

3.2. Fiscal response to COVID-19 crisis – a mixed but transformative approach

3.2.1. Such *mixed approach* has consequentially evolved in the course of 2020 to combine (however in a still incomplete manner) **(i)** the short time introduction of new innovative loan programs modelled on the concept of the predecessor of the ESM [the European Financial Stability Facility (EFSF) established in 2010] and providing urgent financial assistance to Member States in dealing with the emergency labour market related expenditures (in the form of the *SURE mechanism* announced by the Commission in April 2020 and based on Article 122 of the TFEU[48]); **(ii)** the use of the ESM, diluting as much as possible conditionality and related stigma for applying States; **(iii)** involvement on a large scale of the European

[48] See EC, *Council Regulation on the establishment of a European instrument for temporary support to mitigate unemployment risks in an emergency (SURE) following the COVID-19 outbreak* (Proposal, 2 April 2020) COM(2020) 139 final.

Investment Bank (EIB) in the EU financial response package; and, as a more ground-breaking response, **(iv)**, within a somehow larger time horizon and in the context of the decisions on the *seven-year EU budget*, the establishment of a new Recovery Fund oriented towards restarting the economy and supported on an innovative funding process (to start being operated as soon as possible in the course of 2021).

We live in volatile times and there is no purpose in developing here an extensive characterization of a catalogue of EU fiscal responses in the context of an extremely dynamic regulatory and institutional environment. What is relevant is to stress the **overall model for such mixed fiscal reaction**, which ultimately has been made possible within the latitude of a true ***fiscal stabilization function*** that has emerged, however incomplete, from the previous process of *transformation of EMU* (as stressed in the first part, *infra*, **2.**, of this Chapter).

The first two instruments (especially SURE[49]) have to a large extent provided an urgent protection to financially more fragile States in favourable conditions of preferential interest rates and, at the same time, avoiding, for the sake of urgency, a protracted and wider discussion on *risk-sharing*. However, in order to ensure the practical and financial relevance required by the degree of urgency and the intensity of the current economic shock it would be essential that the financial cap of SURE was not too low, so that sizeable loans could be at stake, implying, in turn, that the financial structuring of the mechanism strikes a good balance between the ability to raise funds on the financial markets and the level of capital guarantees that are to be provided by Member States. To a large extent, these goals have

[49] In the case of ESM we refer here specifically to ESM, 'Pandemic Crisis Support', esm.europa.eu/content/europe-response-corona-crisis.

been achieved in the process of implementation of Council Regulation (EU) 2020/672 and, on the whole, it may be considered that an innovative instrument has been put in place, making ample use of the normative basis of Article 122 TFEU allowing the EU to provide '*in a spirit of solidarity'* temporary finance assistance to member States in difficulty due to exceptional circumstances beyond their control. An important element of innovation underlying this SURE regime concerns the actual form of solidarity that supports SURE, through Member States guarantees, irrevocable, unconditional and callable (on a pro-rata basis if any Member State would fail to honour a call on time), which, in turn, duly back borrowing by the Commission on behalf of the EU of up to a maximum of 100 billion Euros on capital markets or with financial institutions. In this context, the first Report on Sure published by the Commission in March 2021 evidences its extremely positive impact on employment and on interest payments savings (with a significant part of financial assistance under SURE being used in support of job retention schemes of the highest relevance during the more critical stages of COVID-19 related lockdowns). The relevance and the innovative elements associated with SURE, and of decisive importance to safeguard social and economic cohesion in unstable times - which will not be definitively overcome in the course of 2021 given the uncertainty of pandemic waves in spite of the ongoing vaccination program - would justify pondering its evolution towards a permanent European unemployment benefit scheme. A scheme that would be added to a renewed EU fiscal policy toolkit, possibly basing it on Article 175(3) TFEU as it happens with other special instruments outside the Multiannual

Financial Framework, e.g., the EU Solidarity Fund or the European Globalisation Adjustment Fund).[50]

3.2.2. As regards a medium term and more structural perspective, which duly takes into account the true dimension of the economic shock, the third and fourth aforementioned options [involvement of EIB and establishment of a new Recovery Fund or, more specifically, of the so called '*next Generation EU (NGEU) Recovery Instrument*'] may provide an answer that avoids the conceptual traps of a protracted and politically toxic discussion on debt mutualisation and corresponding moral hazard [as the one proposed by a group of German economists, in the form of temporary Eurobonds ('*Coronabonds'*) which would involve the implementation of a fully structured common debt instrument at the Eurozone level[51]]

As regards the EIB Group, the creation of a *Pan-European Guarantee fund* (EGF) in response to COVID-19 enables the EIB, in partnership with local lenders and national promotional institutions (which may be key players here in close cooperation with the banking sector), to decisively reinforce its support to

[50] On these possible evolutions of SURE towards a permanent European unemployment benefit scheme and also on the contours of the current SURE regime see, *inter alia*, Sofia Fernandes and Frank Vandenbroucke, 'SURE: A welcome lynchpin for a European unemployment re-insurance' (April 2020) Technical Report, Notre Europe Jacques Delors Institute, institutdelors.eu/wp-content/uploads/2020/04/PP251_SURE_Fernandes-Vandenbrouck_200417_EN.pdf; Francesco Corti and Cinzia Alcidi, 'The time is ripe to make SURE a permanent instrument' (June 2021) CEPS Policy Insights No PI2021-10, ceps.eu/ceps-publications/the-time-is-ripe-to-make-sure-a-permanent-instrument/.

[51] See Michael Hüther et al., 'Europe must demonstrate financial solidarity' (30 March 2020) German Economic Institute, iwkoeln.de/en/press/gastbeitraege/beitrag/michael-huether-europe-must-demonstrate-financial-solidarity.html.

SMEs and corporates in general in the real economy (ensuring at the same time a key involvement of local banks and other financial intermediaries, in close contact with businesses and thus unlocking financing to the real economy). Furthermore, the resources thus obtained, combined with resources from other EU funds, may lead to other forms of *financial engineering* in the various Member States, through special purpose vehicles or comparable entities established at national level, which, in themselves, could also be used to attract complementary financing by private investors. In short, there should be a large potential for EIB - through EGF, hopefully reinforced in the future, and in actual strategic partnerships with the financial sector - to deploy a number of equity, debt funds and guarantee products in cooperation with selected financial intermediaries for the benefit of SMEs which form the backbone of the economy in several Member States (thus also addressing the risks of an uneven recovery in various regions of the EU[52]).

Lastly, and as a new crucial piece of the Post-COVID-19 crisis renewed EU fiscal policy toolkit, the July 2020 European council agreement on the recovery plan (so called 'Next Generation EU') to accompany the Multiannual Financial Framework (MFF) for the period 2021-27 is the more ground-breaking response to the challenges of the crisis and subsequent economic recovery.

The agreement was finally approved in December 2020 after minor amendments agreed with the European Parliament. The commitments involved have a total value of 1.8 trillion Euros [of which roughly 1.07 trillion Euros equals the size of the MFF for 2021-27, while the remaining 750 billion Euros correspond

[52] On these risks of uneven recovery see, *inter alia*, Revoltella and Strauch (n 28).

to the highly innovative Next Generation EU (NGEU) Recovery Instrument]. This comprehends 390 billion Euros in grants and 360 billion Euros in loans to be made available to Member States under certain conditions. The ground-breaking element here has to do with the introduction of a first, indirect, step of European debt mutualisation, as the European Commission will borrow funds on the capital markets, on behalf of the EU, to finance the NGEU. This was based on the Council decision of 14 December 2020 on the system of own resources, establishing rules on the financing of NGEU and authorising the Commission to borrow up to 750 billion Euros in 2018 prices on capital markets, with the decision only entering into force upon approval by all Member States.

Not surprisingly – in light of the recent developments *supra* commented on monetary policy – this measure was challenged at the *Bundesvertassungsgericht* through a request for an injunction that would immediately prevent German ratification of the aforementioned EU own resources decision paving the way to the NGEU recovery fund. A group of German citizens launching this complaint argued that financing the NGEU recovery fund through EU-issued debt would ultimately involve as such mutualisation of debt, thus violating the German Constitution and the TFEU. Although the *Bundesvertassungsgericht*, on 21 April 2021, rejected this request for an injunction,[53] balancing the consequences at stake and pondering the consequences of a delay which would adversely affect in immediate terms the economic policy objective pursued – which, in turn, allowed the German ratification of the EU own resources decision – this does not represent the end of the controversy. In fact, the Court has,

[53] BVerfG, 2 BvR 547/2.

conversely, declared the case as admissible and this may probably lead to the submission of questions to the ECJ in a preliminary ruling procedure and it cannot be entirely ruled out that it might lead to a new sensitive final position of the *Bundesverfassungsgericht* of reserving in the end the right to apply German Constitutional law. That would happen if it would hypothetically view the ECJ judgment as legally unsustainable (a hypothetical outcome which hopefully should be avoided due to its very critical consequences to the primacy of EU law with all its corresponding normative corollaries).[54]

Leaving aside the usual clouds of legal uncertainty, the incoming implementation of the NGEU recovery fund within the adoption of the seven-year EU budget (duly reinforced)[55] is also bound to reinforce the panoply of forms of *fiscal/financial engineering* - the importance of which we have highlighted in connection with EIB financing - fully exploring thus the potentialities of future equity-like funding mechanisms, and supporting investment necessary to ensure repair and recovery actions.[56]

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[54] We have no room here to further pursue this line of critical analysis. On problems arising from this type of highly sensitive and critical judicial controversies within the EU judicial system, see, *inter alia*, European Parliament, 'Primacy's Twilight? – On the Legal Consequences of the Ruling of the Federal Constitutional Court of 5 May 2020 for the Primacy of EU Law' Study requested by the AFCO Committee (April 2021).

[55] See on this Massimo Motta and Martin Peitz 'The EU recovery fund: An opportunity for change' (*VoxEU CEPR*, 30 April 2020), voxeu.org/article/eu-recovery-fund-opportunity-change.

[56] On the potentialities of equity-like funding mechanisms, supported by EU resources on an innovative basis, see, *inter alia*, Arnoud Boot et al., 'Coronavirus and financial stability 3.0: Try equity – risk sharing for companies, large and small' (*VoxEU CEPR*, 3 April 2020), voxeu.org/article/try-equity-coronavirus-and-financial-stability.

As most of the support at stake in this domain will be provided through the Recovery and Resilience Facility (RFF),[57] the access to which is subject to the approval of the so-called *national Recovery and Resilience plans* presented by Member States, which in turn are to follow Commission Guidelines and are to be assessed by the Commission (and then approved by the council) through the European semester mechanism, it is to expected that a proper balance is found here (in terms of autonomy, according to national priorities arising from different economic structures of Member States, and EU coordination).

In fact, while EU mechanisms of intervention and financial assistance in the context of the past sovereign debt crisis were entirely different in nature, it should now be expected a *qualitatively new form of EU coordination*, with some degree of leeway given to Member States (not to be perceived as subject to some form of *lato sensu* stricter 'conditionality') but, at the same time, and through a proper balancing exercise, supplementing the lack of overall coordination of the national fiscal efforts and programs aiming towards economic recovery and ensuring European priorities in terms of long-term productive investment in strategic areas.

4. The COVID-19 crisis and the European banking sector

4.1. The banking sector and the pandemic shock – What is the balance while exiting the crisis?

4.1.1. As aforementioned, the European banking sector, considering *inter alia* the mechanisms of monetary transmission

[57] The Recovery and Resilience Facility (RFF) is the biggest individual program under NGEU, with a total value of 672,5 billion Euros, see EC, 'The Recovery and Resilience Facility', ec.europa.eu/info/business-economy-euro/recovery-coronavirus/recovery-and-resilience-facility_en.

related to it, has been playing a fundamental role in the economic responses to the current exogenous shock. Conversely, as also emphasized in the first part of this article, it has proven absolutely essential the adoption of measures calibrated to prevent an *endogenous risk amplification* effect within the banking sector, which would have disastrous consequences in the present context.

Accordingly, an extensive array of measures and actions have been developed in the EU (especially the eurozone), building decisively on the ***new financial supervisory infrastructure*** created in the wake of the previous crisis and partially correcting the *lack of normative focus in the banking sector* that I have characterized as a *major initial imbalance of the eurozone* (albeit still manifest in the *omission of the banking sector in the provisions of the EU Treaties*, almost incomprehensible given the political relevance of this sector, as underlined *supra*, **2.2.2.**).

As duly highlighted *inter alia* by Isabel Schnabel, the EU banking sector, due to the quick and intense crisis-policy response (referred *supra*), has witnessed a qualitative reinforcement of a so-called **'*sovereign-bank-corporate' nexus*** carrying with it financial stability risks which have been timely addressed during the most critical stages of the COVID-19 crisis.[58] [59] As also stressed by Isabel Schnabel, it may be argued that in stark and virtuous contrast to what happened with the *vicious 'sovereign-bank' nexus* that plagued the Euro area in the preceding crisis, this new nexus, if properly handled, may be

[58] On addressing and monitoring of these risks to financial stability see the latest ECB, *Financial Stability Review* (May 2021), ecb.europa.eu/pub/financial-stability/fsr/html/ecb.fsr202105~757f727fe4.en.html.
[59] See Schnabel (n 14).

the key to a faster and a more consistent post-COVID economic recovery (depending on a proper mix of fiscal and monetary policy measures, as the ones reviewed in the preceding parts of this Chapter, *supra* **2.** and **3.**, also avoiding potential vulnerabilities that would arise from a high degree of divergence among Euro area countries).

This brings us back to the idea, already put forward, of the banking sector evolving and adjusting to ensure it is able to play a pivotal role in the distribution and servicing of government rescue programs, duly supporting at the same time existing clients in spite of the remaining levels of uncertainty. As previously mentioned, this role and evolution has already been conceived as the opportunity '*for a "New Deal"'* between the EU, EU governments and the EU banks'.[60] While I find this designation and concept somehow misleading, implying a too strong idea of public intervention, the fact remains that there is currently room to what may be more appropriately designated as a ***new EU strategic policy for the banking sector***, structured in various regulatory and policy building pieces, to ensure a combination of conditions that may ensure for the banking sector such pivotal role in the distribution and servicing of economic rescue and recovery programs (assuming, in the process, it is duly stabilized and restructured).

It manifestly exceeds the limited purview of this article to review the vast array of measures that have addressed the situation of the banking sector in the bulk of the crisis (namely of the SSM, SRB, EBA, ESRB, in conjunction with the

[60] See on this idea, and already quoted *supra*, Nathanial and Van-der-Hayden (n 32).

Commission).[61] [62] So the purpose here is to tentatively apprehend the **key trends and forces at play as regards the banking sector** and perceive the highly complex **mix of positive and negative dynamics unlashed by the COVID-19 crisis**.

As a starting point to ponder the situation of the banking sector in the wake of more than a year of COVID-19 crisis, it is worth considering the data included in the publication by EBA of its Risk Dashboard for the fourth quarter of 2020 (the latest available).[63] Although this release still concerns the data for end of 2020, in a very dynamic context due, on the one hand, to the EU vaccination program and, on the other hand, to the successive pandemic bouts throughout the first quarter of 2021, it provides anyway a succinct short-term outlook for several risk measures. These, in spite of positive signs, as the continued improvement of capital ratios, the decrease of non-performing loans (NPLs) ratios, largely due to NPL sales, and a marked decline of EBA eligible moratoria (with these moratoria nearly

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[61] For a good overview on this array of measures and actions see European Parliament - Economic Governance Support Unit (EGOV), 'Banking Union: Corona Crisis Effects' Briefing (April 2020), europarl.europa.eu /RegData/etudes/BRIE/2020/645719/IPOL_BRI(2020)645719_EN.pdf .

[62] See also for a comprehensive view of the measures at stake, EBI (n 45). Henceforth, as regards several quoted regulatory measures, the relevant links will be omitted (brevitatis causae) and readers asked to refer to the links contained in the aforementioned EBI Report.

[63] See EBA, *Risk Dashboard – Data as of Q4 of 2020*, eba.europa.eu/ sites/default/documents/files/document_library/Risk%20Analysis%20and% 20Data/Risk%20dashboard/Q4%202020/972092/EBA%20Dashboard%20- %20Q4%202020.pdf; EBA, *Risk Assessment of the European Banking System* (December 2020), eba.europa.eu/sites/default/documents/ files/document_library/Risk%20Analysis%20and%20Data/Risk%20Assess ment%20Reports/2020/December%202020/961060/Risk%20Assessment_R eport_December_2020.pdf.

halving throughout the fourth quarter of 2020), still outline remaining potential vulnerabilities of the banking sector.

In fact, in complementary analyses EBA duly underlines[64] that after a significant progress in the containment of the pandemic by the end of the first semester of 2020, infections have rapidly increased again by the end of 2020 in a new wave of the pandemic, and, accordingly, containment measures have resumed in many EU Member States. That has been largely confirmed, after these EBA assessments, in the beginning of 2021 with the prospects for economic recovery still subject to a high degree of uncertainty (as EBA anticipated), also on account of a slow start of the EU vaccination programs. Within this still uncertain and fluid context, and despite the fundamental progress achieved in the stabilization of the banking sector throughout an acute crisis year, on the side of the persisting vulnerabilities of this sector we should refer the slight decline of return on equity in the fourth quarter of 2020, marking a still relative low profitability of the EU banking sector (especially in comparison with the US banking sector and representing as such an appreciable strategic vulnerability of the EU banking system).

Furthermore, while NPLs decreased, this movement in very uneven in terms of the relative position of the different national banking markets and in terms of the various economic sector at stake, In fact, while the NPL ratios declined for most economic sectors, it conversely increased materially for accommodation and food services, something which is also connected with the uneven evolution of the various national markets, because clearly some Member states economies are more exposed to

[64] EBA, *Risk Assessment of the European Banking System* (December 2020) 10.

those critical sectors (predominantly related with tourism for which recovery will be slower and much more uncertain, thus leading to new fragmentation risks in the EU banking system).

Also, a cause for concern, contrasting with an overall positive scenario, is the fact that in spite of the relative improvement of NPL ratios other metrics show early indications of deterioration in asset quality for the banking sector. This also leads to the crucial issue of pondering how the incoming phasing out of COVID-19-related measures, such as moratoria on loan repayments and public guarantees, will further affect asset quality and highlights the crucial importance of getting right the delineation and implementation of a comprehensive strategy for such phasing out of emergency COVID-19 measures (one of the crucial critical factors for the EU banking system until the end of 2021 and in the transition to 2022, as I shall briefly mention *infra*, **4.2.4.**).

4.1.2. Within this context and seeking an overall view of both the current constraints and the foreseeable perspectives, already envisaging in the wake of the acceleration of the EU vaccination program by the end of the first semester of 2021 a path of economic recovery, we may consider, on the **negative side**, a **triangle of chief risks** for the functioning of the banking sector and, conversely, on the **positive side**, a **triangle of potential opportunities** for a favourable repositioning of this sector.

Firstly, as regards the **triangle of risks** we may refer the **(i)** negative dichotomy of *persisting low profitability* and *credit risk*; in this later case, creating uncertainties as regards the previous trend towards reduction of past non-performing loans (NPLs) (with rising default rates and higher provisioning needs); **(ii)** *risks arising from inadequate management of the margin of flexibility granted by supervisors and regulators* in view of the COVID-19 exceptional circumstances; and **(iii)** *potential imbalances in the functioning of the Banking Union* largely arising from the fact that financial support measures or financial stabilisation tools addressed to banks under conditions of financial stress are still mainly taken at national level (which may both contribute to fragmentation on national lines of the banking sector and to uncertainty as regards admissible instruments to manage pre-crisis situations by individual institutions).

Secondly, as regards the **triangle of potential opportunities** for the banking sector, we may consider **(i)** an acceleration and diversification of the digitalisation of banking, along a path of various alternative models (due to the adaptation to telework and increased needs of digital interaction with all the players in banking transactions); (**ii)** a transition to renewed business models coupled with new market incentives to banking consolidation (hopefully, as I shall refer *infra*, **4.3.2.**, a '***smart banking consolidation*'**), and **(iii)** a renewal of management culture, more client-oriented and also - due to regulatory and supervisory incentives (SSM and EBA playing a key role here in interaction with national authorities) – oriented towards a significant increase of cost-efficiency, enhancing a more positive image of the banking sector and fundamentally redressing the public image and cultural problems arising from the last endogenous crisis of the financial sector.

4.2. The banking sector and the pandemic shock – What is the balance while exiting the crisis?

4.2.1. One of the critical challenges that have confronted banks in the most critical stages of the crisis involved, as aforementioned, increasing credit risks and the way to balance adequately the management of such risks *vis a vis* the pressing needs of continuous support to the economy. A balance has to a large extent been achieved here through the EBA Guidelines '*on legislative and non-legislative moratoria on loan repayments in the light of the COVID-19 crisis*'[65], followed by national measures introducing moratoria on payments of credit obligations and providing public guarantees to ensure that banks continue helping small, medium-sized and large enterprises. These have also been followed up in the *Banking Package* adopted in 28 April 2020 by the Commission,[66] namely in its *Communication on the application of the accounting and prudential frameworks to facilitate EU bank lending*, where, *inter alia*, special leeway was advocated in the assessment of a significant increase in credit risk (SICR), somehow discounting, within certain limits, sudden punctual increases in the probability of default caused by the COVID-19 crisis (and bearing in mind with due flexibility the remaining lifetime of the financial assets concerned). The aforementioned EBA *Guidelines* have also been highly relevant in order to introduce some clarity and consistency in these types of assessment, setting out criteria to be fulfilled by *payment moratoria* in order not to trigger forbearance classification.

[65] EBA, *Guidelines on legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis* (2 April 2020), eba.europa.eu/regulation-and-policy/credit-risk/guidelines-legislative-and-non-legislative-moratoria-loan-repayments-applied-light-covid-19-crisis.

[66] I refer here to: EC, 'Interpretative Communication on the application of the accounting and prudential frameworks to facilitate EU bank lending Supporting businesses and households amid COVID-19' (Communication from the Commission to the European Parliament and the Council Commission, 28 April 2020) COM/2020/169 final; and EC, *Regulation of the European Parliament and of the Council amending Regulations (EU) 575/2013 and (EU) 2019/876 as regards adjustments in response to the COVID-19 pandemic* (Proposal, 28 April 2020) COM/2020/310 final.

Furthermore, the *Guidelines* have also helped address short-term liquidity difficulties resulting from the constraints in operations of businesses and individuals in the context of the pandemic, having been duly followed up by the subsequent *EBA Statement on additional supervisory measures in the COVID-19 pandemic*[67] with a focus on permanent review and preparedness by banks of key elements of effective crisis management.

In any case, and in spite of the various elements of special flexibility introduced, in a scenario of asymmetric recovery with some sectors taking longer time to recover in a volatile context of significant uncertainty, the balancing exercise by banks of, on the one hand, preserving asset quality and, on the other hand, maintaining financial support to the economy, will prove sometimes difficult (as banks might have to focus more on managing existing credit lines of potentially distressed borrowers rather than extending new lending).

Also important, to tackle the tensions related with the levels of credit risk and potential credit losses have been the measures adopted by SSM on the application of accounting rules asking banks to avoid pro-cyclical assumptions in their expected credit loss estimates under the International Financial Reporting Standards 9, or IFRS 9.[68]

As a further element to ease the tensions here at stake, we should mention the second component of the Commission's

[67] See EBA, 'EBA Statement on additional supervisory measures in the Covid-19 pandemic' (22 April 2020).

[68] See on this ECB Banking Supervision, 'ECB Banking Supervision provides further flexibility to banks in reaction to coronavirus' (Press Release, 20 March 2020), bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200320~4cdbbcf466.en.html; EC (n 66).

Banking Package of 28 April 2020: namely, the adoption of Regulation (EU) 2020/873, which amends *the EU Capital Requirements Regulation (CRR)* as previously adjusted in 2019, to incorporate the last elements of the finalised Basel III framework,[69] including a delayed timeline for implementing those elements and introducing a revised treatment of publicly guaranteed loans under the prudential backstop for NPLs (considering the preferential treatment on provisioning requirements under Article 47c of the CRR), in connection with the aforementioned supervisory flexibility given by the SSM to the treatment of NPLs. (thus, trying to provide some extra leeway for the banks to further support the economy in the exceptional context of the ongoing crisis).

4.2.2. The second vertex in the triangle of major risks confronting the banking sector concerns possible mismanagement of the special margin of flexibility granted by supervisors. Again, the longer the exceptional circumstances prevail, the more difficult it is to calibrate and to monitor a temporary flexible supervisory framework. This implies, *inter alia*, for the SSM – in articulation with national supervisors, EBA and also the SRB - to permanently adjust the *Supervisory Review and Evaluation Process* (SREP) in the course of 2020 and 2021, in order to timely apprehend and prioritize unfolding risks for individual banks and their effective capacity to cope with such risks (also involving a permanent focus in pondering successive hypothetical shocks and corresponding vulnerabilities that may affect differently various individual

[69] See Regulation (EU) 2020/873 of the European Parliament and of the Council of 24 June 2020 amending Regulations (EU) 575/2013 and (EU) 2019/876 as regards certain adjustments in response to the COVID-19 pandemic [2020] OJ L 204/4.

banks, *something which is not made easier by the convenience of easing the daily compliance constraints on supervised banks*).

If, understandably, the SSM has temporarily suspended or delayed the implementation of multiple supervisory decisions[70] and somehow relieved the pressure on the implementation of banks' ongoing plans for reducing past NPLs. that has inevitably involved a *trade-off* with the need for enhanced scrutiny of new emerging risks, rendered even more complicated with the passing of time and the accumulation of financial tensions.

Furthermore, other layers of flexibility concerning green light for supervised banks to operate below the level of capital defined by the Pillar 2 guidance and full use of their capital buffers for as long as necessary, taking stock of large liquidity buffers built over recent years,[71] were undoubtedly justified in the most acute period of the crisis, but, once more, the sustainability of this margin of flexibility will come under pressure with the passage of time and with the uncertain rhythm and dimension of the economic recovery (bearing in mind the critical lessons learned on liquidity risks in the last financial crisis).

Nevertheless, at this point, and with the hindsight of more than one year of crisis management, it may be assumed, on a positive note, that this second risk of hypothetical mismanagement of the

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[70] As acknowledged by the Chair of SSM, see, Andrea Enria, 'How European Banking Supervision can help fight the economic consequences of the coronavirus outbreak in Europe' (1 April 2020) ECB Banking Supervision Opinion Piece, bankingsupervision.europa.eu/press/interviews/date/2020/html/ssm.in200401~c19a2ad1ed.en.html.

[71] ibid.

special margin of flexibility granted by supervisors has been, on the whole, successfully contained by the EU supervisors (especially the SSM).

4.2.3. Finally, the relative incompleteness of the Banking Union as regards European financial support or financial stabilisation tools of banking, in spite of the undeniable progress achieved with the implementation of the European resolution regime, and the legal grey areas that persist concerning admissible national pre-crisis interventions and European resolution interventions – and the interplay between the state aid and resolution regimes - may lead to difficulties and renewed tensions and risks of fragmentation of the Banking Union, which will have to be timely tackled. Precautionary recapitalization of banks may be one of those critical grey areas, requiring a new focus and, possibly, an overall review of the 2013 *Banking Communication* (in spite of some minor element of increased flexibility that result from the articulation between this Communication and the new Commission *Communication on the Temporary Framework for State Aid Measures to Support the Economy in the Current COVID-19 Outbreak*).[72]

4.2.4. Considering this aforementioned context, and the positive evolution in the course of the first months of 2021, the key challenge now is how to devise and adequately implement a consistent phasing out strategy from the COVID-19 related emergency framework (loosely described *supra*). A crucial

[72] I refer here to: EC, 'Application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis' ('Banking Communication') (Communication, 30 July 2013) OJ C 216/1; and EC, 'Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak' (Communication, 20 March 2020) C/2020/1863, OJ C 91 I/1.

element for this overall exit strategy[73] will undoubtedly be to restore some measure of bank balance-sheet transparency. If this goal may be assumed as almost consensual, conversely the calibration of its implementation is bound to raise all sorts of doubts.[74] To achieve such prevailing goal borrower relief measures – in particular moratoria – will have to be phased out ahead of phasing out other measures as a vital first step, but that will have to be carefully pondered through a gradual approach and proper communication channels (taking into account that certain undertakings and particular economic sectors may require prolonged forms of support on the basis of the evolution of the pandemic and of the foreseeable uneven path of recovery among different sectors, with the aggravating factor that the more critical economic sectors may be unevenly concentrated in some Member States and their corresponding domestic banking markets).

An important factor in the calibration of this overall strategy will also be the new round of stress tests to be developed in the Summer of 2021[75] and a parallel consistent supervisory action

[73] This strategy should also build on the basis of overall assessments and critical balances of the exception frameworks put in place, as the one provided by the EBA, *Report on the Implementation of Selected Covid-19 Policies* (29 January 2021) EBA/REP/2021/02.

[74] See on that key assumption, *inter alia*, Thorsten Beck et al., 'When and how to unwind Covid-support measures to the banking system?' In-depth analysis requested by the ECON Committee European Parliament (March 2021). While agreeing with the authors on such key initial assumption, as far as I am concerned a *nuanced* and gradual approach must be carefully pondered in this sensitive field. See, also, on this point, ESRB, 'Financial stability implications of support measures to protect the real economy from the COVID-19 pandemic' (Press Release, 16 February 2021) esrb.europa.eu/news/pr/date/ 2021/html/esrb.pr210216~4d9cec6a0b.en.html.

[75] See Patrizia Baudino, 'Stress-testing banks during the Covid-19 pandemic' (October 2020) Financial Stability Institute Briefs No 11, bis.org/ fsi/fsibriefs11.pdf (on the prospects and particular conditions of stress-testing

orienting banks towards recognising potential credit impairments without much delay, making use of the significant room for loss absorption available to a significant part of the banking sector, bearing in mind namely, as recently highlighted by Andrea Enria, the buffer flexibility granted by the SSM and including the capital conservation buffer that remains valid until at least the end of 2021.[76]

At another level, it should perhaps be acknowledged that the incoming and foreseeable steps of implementation of a phasing-out overall strategy from payment holidays and public support schemes (consider here in particular, as aforementioned, bank moratoria), will, almost inevitably, lead, at least in certain segments, to a new peak of NPLs (although not dwelling here on specific numbers and more severe hypothetical ECB and EBA scenarios). This – as previously observed, will be combined with long-term profitability problems in the banking sector, which clearly have not encouraged NPL provisioning, and an expedite recognition of NPL-related losses. So, addressing in a precautionary manner a worst-case scenario, it might be considered that we need – as a matter of some urgency – an efficient and functioning strategy to deal with a potential, even if circumstantial, peak of COVID-related NPLs (which will differ from the legacy assets of the previous crisis). The good news here is that the Commission significantly closed the year 2020 with the publication of a Communication with its priorities to tackle NPLs involving a legislative and regulatory

during the pandemic, allowing some assumptions to stress-testing in the wake of the pandemic).

[76] See on this Andrea Enria, 'European banks in the post-Covid-19 world' (Speech at the Morgan Stanley Virtual European Financials Conference, Frankfurt am Main, 16 March 2021), bankingsupervision.europa.eu/press/speeches/date/2021/html/ssm.sp210316~55c3332593.en.html.

effort to expand, as quickly as possible, secondary distressed loan markets where banks can sell NPLs.[77] The least good news is that we seem at this stage far from a deeper discussion on and around another positive step that would be a pan-European asset management company, more commonly referred as a European Bad Bank, somehow promoted by the Chair of SSM, Andrea Enria, in comments in October 2020 in the Financial Times[78] [even if *multiple variants* or *sub-variants* for that development could or should be considered and discussed, in the form e.g. of *networks of smaller and privately funded asset management companies (AMCs*)].

4.3. The banking sector and the pandemic shock – What is the balance while exiting the crisis?

4.3.1. The aforementioned risks and the associated exit strategies from the exceptional COVID-19 framework are conversely entangled with positive opportunities of transformation for the banking sector, although it might still be too soon to ascertain what will ultimately be the prevailing dynamic.

The first vertex of the virtuous triangle of opportunities for the banking sector concerns a possible *acceleration of digitalisation* due to the adaptation required in these times of increased digital interactions (arising from social distancing and also from reduced economic trade and travelling). In fact, these

[77] See EC, 'Tackling non-performing loans in the aftermath of the COVID-19 pandemic' (Communication from the Commission to the European Parliament, the Council and the European Central Bank, 16 December 2020) COM/2020/822 final.
[78] See Andrea Enria, 'ECB: the EU needs a regional 'bad bank'' (*Financial Times*, 26 October 2020), ft.com/content/cc3a9a51-4d9a-4c73-9ff0-9f623ecf4065.

new pressures towards digital financial innovation may push banks towards a quicker and more efficient transition to a digital environment and infrastructures. Such transition is, under the present conditions, bound to comprehend both more basic logistical means of transaction and more strategic financial fundamentals.[79]

Against this new background, it might be possible to anticipate three alternative lines of evolution towards *increased digital banking*, including, namely **(i)** the establishment by traditional banks of internal (in-house) specialised units, including branches particularly dedicated to the development and enhancement of digital technologies; **(ii)** the development of new digital business models through an increased movement of joint ventures between banks and FinTechs and technological companies and, lastly, **(iii)** the development of specialised *fora* for cooperation between banks, FinTechs and technological companies, programming, as much as possible, a smooth transition to digital environments in multiple business areas (also with potential involvement of regulators in such *fora*).[80]

4.3.2. This prospective accelerated digitalisation is bound to be combined with an adaptation of the banking business model, involving new forms of interaction with clients and, also, **new**

[79] On these possible trends see, *inter alia*, James Eyers and James Frost, 'How the coronavirus will change banking' (30 March 2020) The Australian Financial Review; Douglas W Arner et al., 'Digital Finance & the Covid-19 Crisis' (2020) University of Hong Kong Faculty of Law Research Paper n 2020/017.

[80] These alternative lines of evolution, relying on *intense cooperation between different entities*, will probably raise competition law problems in combination with financial regulation issues. On such problems of *cooperation*, also comprehending JVs in the financial sector, see, Luís Silva Morais, *Joint Ventures and EU Competition Law* (Oxford, Hart Publishing 2013).

market incentives to *banking consolidation*. In fact, while it is widely acknowledged that significant hurdles remain in the EU as regards further banking consolidation for a variety of reasons that EBA had recently analysed (right before the irruption of the COVID-19 shock),[81] the almost inevitable financial and operational constraints which will affect some more fragile banks may lead to a virtuous cycle of *market-oriented bank consolidation* (which is much more positive and virtuous than any type of *regulator-induced consolidation* even if some measured *indirect regulatory incentives* to some forms of consolidation could be contemplated as part of what I have *supra* designated as a ***new EU strategic policy for the banking sector***).

Within this – always limited to my mind - *indirect regulatory incentives* to some forms of consolidation we may consider certain elements of the 2020 *ECB Guide on the supervisory approach to consolidation in the banking sector*, particularly the ones which are somehow supportive of forms of **consolidation** that may allow banks to more thoroughly **explore the opportunities for economies of scale related with digital transformation of their business models**

This should correspond, in any case, to what we may designate as a movement of '**smart consolidation**' within the EU banking system – as part of the aforementioned *EU strategic policy for the banking sector* – leading hopefully to a *differentiation and segmentation of the banking system into three or more major types of business models and categories of players*, including namely: **(i)** larger transnational European groups oriented

[81] See Anna Gardella, 'Potential Regulatory Obstacles to Cross-Border Mergers and Acquisitions in the EU Banking Sector' (February 2020) EBA Staff Paper Series n 7.

towards international businesses, **(ii)** a significant group of smaller, medium sized (at an European scale) and more focused commercial banks and **(iii)** a diversified group of networks of local saving banks, efficiently serving retail clients and communities, with a particular business model based on proximity and also on special support to specific economic activities. An adequate (a) application of proportionality parameters in banking supervision, combined with (b) other various regulatory instruments following on certain market dynamics, and making room for (c) innovative forms of cooperation, involving different degrees of intensity that would comprehend Institutional Protection Systems (SPIs) as prudentially designed in the CRR but also other looser forms of cooperation and mutual financial assistance (to be acknowledged as such by bank supervisors) - within different networks of local or community banks - may correspond to building blocks of a new *EU strategic policy for the banking sector*, leading to a ***smart banking consolidation*** of the EU banking system in the wake of the COVID-19 crisis.

4.3.3. Lastly, and concluding on a positive note, an efficient response by the banking sector to the current situation of distress, taking fully stock of all the supervisory and foreseeable public mechanisms to be put in place in order to anchor a continuous support of banks to their client basis, may produce a complete overhaul of the negative legacy in terms of business and cultural image that had resulted from the previous great financial crisis.

If, hopefully, all these conditions essentially concur, an historical paradox might occur as – out of the blue – one major economic crisis, of an exogenous nature, would thus correct the failures attributed to the banking sector on account of a previous endogenous crisis of this sector.

Time will tell presently if this positive outcome materialises or if the pendulum will swing the other way, towards a negative materialization of the risks impeding on the banking sector, but the prospects of a much quicker than expected economic recovery in the course of 2021, due to vaccination gaining momentum after an initial shaky start at the EU, provide a perhaps unique opportunity for a positive strategic transformation or overhaul of the European banking system.

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SECTION V:
CAPITAL MARKETS REGULATION

16. Emergency measures for equity trading: the sase against short selling bans and stock exchange shutdowns

Luca Enriques & Marco Pagano

* * *

1. Introduction

At the outbreak of the COVID-19 crisis, traded financial assets prices abruptly plunged. The clear prospect of an almost unprecedented decrease in supply and demand in the near future given the lockdowns, coupled with extreme uncertainty about the longer-term prospects for the economy worldwide, justified such sharp price adjustments. Yet, in conditions of plummeting prices and high volatility, policymakers around the world felt under pressure 'to do something' to stop the downward trend in market prices.[1] During the financial crises of 2008-09 and 2011-12, these pressures led to the adoption of short selling bans.

[1] See generally Luca Enriques, 'Regulators' Response to the Current Crisis and the Upcoming Reregulation of Financial Markets: On Reluctant Regulator's View' (2009) 30 University of Pennsylvania Journal of International Law 1147-1151.

During the present crisis, a number of European national securities regulators, with the approval of the European Securities and Markets Authority (ESMA), reinstated such bans.[2] In addition, both in Europe and in the US, there have been calls for an even more drastic measure: a total shutdown of stock exchanges.[3] To be clear, not just 15-minute circuit breakers, like the US exchanges have in place, but a lasting 'stock exchange holiday'. This chapter reviews the evidence on the effects of short selling bans during the financial crisis and discusses the merits of stock exchange holidays.

2. How effective are bans on short sales?

Few things are more predictable than loud demands for regulatory interventions to 'stop speculation' when stock market prices plunge: in these days, as in any recent stock market crash, we hear politicians and commentators inviting regulators to enact interventions spanning from stock trading suspension to a short sales ban. In the past, stock market regulators typically bowed to such demands: banning short sales is almost their 'Pavlovian response' when faced with widespread drop in stock market prices.

Over the last twenty years, unfortunately there has been no shortage of crises, so that we have had the opportunity to observe this 'Pavlovian response' of regulators repeatedly and in many countries. On 19 September 2008, immediately after

[2] See below n 14.

[3] See Alexandra Andhov, 'Covid-19: Should We Close Stock Exchanges?' (*Oxford Business Law Blog*, 24 April 2020), law.ox.ac. uk/business-law-blog/blog/2020/04/covid-19-should-we-close-stock-exchanges; Matt Levine, 'Everyone Could Use a Little Break' (*Bloomberg*, 27 March 2020), bloomberg.com/news/news letters/2020-03-27/money-stuff-everyone-could-use-a-little-break (discussing the issue).

the Lehman collapse shook investors' confidence in the soundness of banks and brought down the prices of their shares, the Securities and Exchange Commission (SEC) banned short selling of shares in US banks and financial companies. This ban was quickly imitated by the majority of other countries: some only banned 'naked short sales', in which the seller does not borrow shares to deliver them to the buyer during the settlement period; others also banned covered short sales, in which the seller protects himself by borrowing the shares. During the sovereign debt crisis of 2011-12, regulators in most Eurozone countries reacted in the same way to share prices drops, especially those in the banking sector.

These hasty interventions, while varying from country to country in intensity, scope and duration, were invariably presented as aimed at restoring the orderly functioning of the markets and avoiding unwarranted drops in stock prices, and their destabilizing effects. For example, in 2008 the SEC justified its intervention with these words: 'unbridled short selling is contributing to the recent sudden price declines in the securities of financial institutions unrelated to true price valuation'.[4] In the UK, the Financial Services Authority motivated the short selling ban it introduced on 18 September 2008 for financial stocks as follows: 'sharp share price declines in individual banks were likely to lead to pressure on their funding and thus create a self-fulfilling loop'.[5] Similarly, in 2012 the Spanish stock market regulator (CNMV) explained its decision to retain the ban introduced in 2011 arguing that

[4] SEC, 'SEC Halts Short Selling of Financial Stocks to Protect Investors and Markets' (SEC Press Release 2008-211, 19 September 2008) sec.gov/news/press/2008/2008-211.htm.
[5] FSA, 'Short Selling' (February 2009) Discussion Paper 09/1, sbai.org/wp-content/uploads/2016/04/fsa_short_selling_2009.pdf.

‘failure to ban short sales would heighten uncertainty’, and that accordingly keeping the ban was ‘absolutely necessary to ensure the stability of the Spanish financial system and capital markets’.[6] In short, the conditioned reflex of the regulator rests on this argument: in times of crisis, stock prices fall below their ‘true valuation’, which can destabilize banks and, therefore, the financial system. By prohibiting short selling, we prevent too pessimistic investors from ‘expressing their opinions’ on the market regarding the value of the shares, hence we avoid the destabilizing undervaluation that would follow.

While apparently sensible, this argument has serious flaws, both in principle and in fact. First, the argument assumes that regulators know better than the market what the ‘true valuation’ of securities is, better than the thousands of investors who spend huge resources every day to also try to calculate such true valuations, so as to buy undervalued securities and sell overvalued ones. However, if that is the case, why don’t the authorities that oversee security markets intervene even when prices rise above ‘true valuations’, before the market crashes? If we ban short sales to prevent unwarranted price drops, we should symmetrically ban margin trading (the borrowing of money to buy shares) leading to unwarranted security market booms.

Second, the empirical evidence that has accumulated over the years, especially in the last two decades, shows that the ban on short selling is neither able to support security prices, nor to

[6] CNMV, ‘Decision by The CNMV to Impose, Effective Immediately and for a Period of 3 Months, Restrictions on Short Selling and Similar Transactions under Article 85.2.J) of the Securities Market Act and Article 20 of Regulation (EU) 236/2012, due to the Existence of Exceptional Circumstances’ (1 November 2012), cnmv.es/loultimo/prorroga%201%20 nov_en.pdf.

make banks more stable. In a 2013 article by Alessandro Beber and one of us,[7] we analysed daily data on 16,491 shares in 30 countries between January 2008 and June 2009. Our results indicate that the short selling bans implemented over those months did not go hand in hand with increases or lower drops in the stock prices, except in the United States in the two weeks following the application of the ban, an exception probably due to the simultaneous announcement of bank bailouts by the United States government. In other countries, where the bans were not accompanied by announcements of bank bailouts, or also targeted non-bank shares, or did not target bank shares at all, the bans on short selling do not seem to have supported security prices. The estimates indicate that banning naked short sales did not have significant effects on share prices, and banning covered short sales even made them decrease. A subsequent work carried out by one of us with Alessandro Beber, Daniela Fabbri and Saverio Simonelli in 2018 also shows that, contrary to what regulators expected, banks whose securities were subject to short selling bans even featured an increased probability of insolvency, compared to other banks of similar risk and size but exempt from the ban.[8]

[7] See Alessandro Beber and Marco Pagano, 'Short-Selling Bans Around the World: Evidence from the 2007–09 Crisis' (2013) 68 Journal of Finance 343. Two studies on the effects of the 2020 short selling bans confirm Beber and Pagano's results. See Pasquale Della Corte et al., 'Short-Selling Bans in Europe: Evidence from the COVID-19 Pandemic' (2020) ssrn.com/abstract=3692789; Gianfranco Siciliano and Marco Ventoruzzo, 'Banning Cassandra from the Market? An Empirical Analysis of Short-Selling Bans during the Covid-19 Crisis' (2020) 17 European Company and Financial Law Review 386.

[8] See Alessandro Beber et al., 'Short-Selling Bans and Bank Stability' (2021) 10 Review of Corporate Finance Studies 158.

An obvious criticism of these findings is that short selling bans are not imposed randomly, but in situations of high stock price volatility and to cover the stocks of distressed companies, so the correlation between short selling bans and bank instability cannot be interpreted as a causal relationship. To take the endogeneity of short sales bans into account, Beber et al. (2018) instrument the 2011 ban decisions with regulators' propensity to impose a ban in the 2008 crisis, that is, use the data from the first crisis to infer the propensity of regulators to impose a short selling ban in the second crisis. The results from this exercise indicate that, once one takes the endogeneity of the policy response into account, short selling bans are estimated to be even more destabilizing for the financial institutions whose shares are subject to the ban.

Third, the empirical evidence shows that short selling bans have significant negative side effects. They tend to considerably reduce the liquidity of the markets, because they are accompanied by an increase in bid-ask spreads, especially for smaller companies: reducing market liquidity is particularly damaging in crisis conditions, when liquidity is already in short supply and investors seek it desperately.[9] Furthermore, these bans substantially reduce the informational efficiency of security markets, that is, the speed with which new information is impounded in prices: trying to 'silence the pessimists' makes everyone less informed and thus *increases* market uncertainty. This not only suppresses the negative information that short sellers initially bring to the market, but also the positive one

[9] For a literature review on the effects of short selling bans on market quality see Stefano Alderighi and Pedro Gurrola-Perez, 'What Does Academic Research Say About Short-selling Bans?' (*World Federation of Exchanges,* 2020), world-exchanges.org/our-work/articles/wfe-research-what-does-academic-research-say-about-short-selling-bans.

that they convey once the crisis hits the bottom: at that stage, to profit from their downward bets, short sellers have to enter the market and buy, thus issuing the signal that the bottom has been reached.

Finally, short selling bans make it difficult for investors wishing to take bets on specific stocks to hedge against market-wide movements: hedge funds betting that individual stocks will outperform the market often protect themselves against the risk that a market-wide or industry-wide downward trend will negatively affect their trade by going short on a basket of shares in the same market or industry. If short positions are prohibited, this is not possible and hence there will be fewer traders willing to exploit their stock-specific information; also, on this account price discovery will be impaired.

The conclusion is therefore well summarized by the words pronounced on 31 December 2008 by the former president of the SEC, Christopher Cox: 'Knowing what we know now, I believe on balance the commission would not do it again. The costs (of the short selling ban on financial stocks) appear to outweigh the benefits'.[10]

Policymakers in a number of European countries appear not to have learnt that lesson. Italian, French, Austrian, Greek, Belgian, and Spanish securities regulators all introduced temporary bans on short selling in March 2020.[11] Italy's ban was originally for three months, while other regulators started

[10] Rachelle Younglai, 'SEC Chief Has Regrets over Short-selling Ban' (*Reuters*, 31 December 2008), reuters.com/article/us-sec-cox/sec-chief-has-regrets-over-short-selling-ban-idUSTRE4BU3GG20081231.

[11] See Philip Stafford, Laurence Fletcher, David Keohane, 'Europe Extends Short-Selling Bans despite Hedge Fund Pressure' (*Financial Times*, 15 April 2020), ft.com/content/d615a15d-c524-4383-b829-4f1a244db28a.

with one-month bans and extended them for another month before they elapsed.[12] As required by the Short Selling Regulation[13], ESMA authorized all of the bans[14] and, prior to that, temporarily required holders of net short positions in shares traded on a European Union regulated market to notify the relevant national competent authority if the positions reache or exceed 0.1% of the issued share capital.[15] By raising the costs

[12] All the bans, including Italy's, ceased to have effect on 18 May 2021. See esma.europa.eu/sections/short-selling.

[13] Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on Short Selling and Certain Aspects of Credit Default Swaps, [2012] OJ L86/1 (EU Short Selling Regulation), Article 27.

[14] See ESMA, 'Opinion of the European Securities and Markets Authority of 17 March 2020 on a Proposed Emergency Measure by the Commissione Nazionale per le Società e la Borsa under Section 1 of Chapter V of Regulation (EU) No 236/2012' (17 March 2020), esma.europa.eu/press-news/esma-news/esma-issues-positive-opinion-short-selling-ban-italian-consob-1; ESMA, 'Opinion of the European Securities and Markets Authority of 18 March 2020 on a Proposed Emergency Measure by the Autorité des Marchés Financiers under Section 1 of Chapter V of Regulation (EU) No 236/2012' (18 March 2020), esma.europa.eu/press-news/esma-news/esma-issues-positive-opinion-short-selling-ban-french-amf; ESMA, 'Opinion of the European Securities and Markets Authority of 19 March 2020 on a Proposed Emergency Measure by the Hellenic Capital Market Commission under Section 1 of Chapter V of Regulation (EU) No 236/2012' (18 March 2020), esma.europa.eu/press-news/esma-news/esma-issues-positive-opinio ns-bans-net-short-positions-belgian-fsma-and-greek; ESMA, 'Opinion of the European Securities and Markets Authority of 19 March 2020 on a Proposed Emergency Measure by the Financial Securities and Markets Authority under Section 1 of Chapter V of Regulation (EU) No 236/2012' (18 March 2020), esma.europa.eu/press-news/esma-news/esma-issues-positive-opinions-bans-net-short-positions-belgian-fsma-and-greek; ESMA, 'ESMA Issues Positive Opinions on Short Selling Bans by Austrian FMA, Belgian FSMA, French AMF, Greek HCMC and Spanish CNMV' (Press release, 15 April 2020), esma.europa.eu/press-news/esma-news/esma-issues-positive-opinions-short-selling-bans-austrian-fma-belgian-fsma.

[15] ESMA, 'ESMA Requires Net Short Position Holders to Report Positions of 0.1% and Above' (Press Release, 16 March 2020), esma.europa.eu/press-news/esma-news/esma-requires-net-short-position-holders-report-positions-

of holding a net short position of that size, such a measure also acts as an indirect curb on short selling.

3. Should exchanges be shut down?

If stocks were still traded in pits, stock exchanges would have been shut down everywhere as COVID-19 spread throughout the world. A bunch of men shouting and feverishly passing each other sheets of paper[16] would have spread coronavirus faster than the now infamous Korean sect.[17]

But stock exchange trading was automated everywhere long ago.[18] Nowadays, the only virus that can be transmitted by trading shares is panic selling. Is that an even better reason for shutting down stock markets, as, among others, some high-profile Italian politicians suggested in March 2020?

Reassuringly, back then the Italian Government ignored the suggestion and the Italian securities' regulator, Consob,

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01-and-above. This decision was renewed in June 2020, September 2020 and December 2020 and expired only on 19 March 2021. See esma.europa.eu/sections/short-selling.

[16] As famously epitomized in the orange juice futures trading scene at the end of *Trading Places* (1983), see youtube.com/watch?v=obAoPP1bdIM. And see also the scene depicting trading at the Rome Stock Exchange back in the early 1960s in Michelangelo Antonioni's *L'eclisse* (1962), youtube.com/watch?v=WtxbbfENLdA.

[17] Billy Perrigo, 'South Korean "Cult" at Center of Local Coronavirus Outbreak' (*Time*, 20 February 2020), time.com/5787898/south-korea-coronavirus-sect.

[18] Not completely, though. Some exchanges still have 'floors' where a small amount of trading still takes place. Needless to say, in response to the Covid-19 pandemic, such floors have been shut down across the globe in March 2020. See e.g. Steven Zeitchik, 'With Stock-exchange Floor Closed, Traders and Investors Grapple with Uncertainty' (*Washington Post*, 8 April 2020), washingtonpost.com/business/2020/04/08/with-stock-exchange-floor-closed-traders-investors-grapple-with-uncertainty.

responded to such calls by appealing to reasonableness and reminding everyone that '[t]he trading halt of all stock market negotiations … would be a decision that would switch off the price indicator without removing the causes, generating market problems that are not easy to solve in the immediate future.'[19] In other words: a stock exchange shutdown is the financial equivalent of getting rid of the thermometer when it signals fever: the only outcome is that it becomes more difficult to understand how serious the flu is and how it is evolving.

A stock exchange shutdown also means putting more pressure on other financial instruments whose prices are correlated to those of shares. Think of an investor who held both Italian equity and Italian Treasury bonds in their portfolio in March 2020. If they assumed that COVID-19 would have a greater economic impact in Italy than elsewhere, perhaps because of its higher sovereign debt-to-GDP ratio than in neighbouring countries, they might have wanted to reduce their exposure to the country. To compensate for not being allowed to sell the equity, they would have sold more Treasury bonds, thereby contributing to the rise in their interest rates. Should Italy then also have banned Treasury bond trading? Treasury bonds are traded outside Italy as well. A shutdown limited to domestic trading venues would only have drained liquidity in the bonds market and hence made it more onerous for the state to issue new bonds (something the Italian state does every few weeks). It would thus have led to the Government (hence, Italian taxpayers) having to pay higher interest rates in the attempt of stopping downward speculative pressures on the

[19] See Consob (Press Release, 9 March 2020), consob.it/web/consob-and-its-activities/news-in-detail/-/asset_publisher/kcxlUuOyjO9x/content/press-release-9-march-2020-hp/718268.

equity market. To put it in another way, an attempt to curb the losses of the minority of Italian citizens who were invested in shares[20] would have come at the expense of taxpayers generally.

Additionally, the result of shutting down the stock exchange is to make the savings of those who are invested in it unavailable at a time of emergency, which is exactly when savers/investors may need to convert them into cash. This would be true not only for those who had bought shares directly, but also for those who had done so via mutual funds: how can an asset manager accept withdrawal requests if they cannot sell the assets in the fund's portfolio and it is impossible to determine their value? In all likelihood an asset manager would make use of their power, according to the contract with the unitholders, to suspend withdrawals until the stock exchange reopens.

Finally, the most intractable problem with shutting down exchanges is the fact that sooner or later they have to be reopened. Had stock exchanges been shut down in March 2020, for how long should stock exchanges have been closed? A few days would have made no difference, as the experience in Sri Lanka and the Philippines in mid-March 2020 showed.[21]

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[20] The Italian pension system is a 'pay-as-you-go' system and Italian pension funds' exposure to Italian equity at the end of 2018 was negligible (€1.2 billion euro). See COVIP, *Relazione per l'anno 2018* (2019) 9, covip.it/?cat=35; or 0.22 per cent of the Italian stock exchange capitalization at the same date, see Borsa Italiana, 'Review dei Mercati 2018' (Press release, 28 December 2018), borsaitaliana.it/borsaitaliana/ufficio-stampa/comunicati-stampa/2018/ review-mercati-2018.htm.

[21] See Chad Bray and Alison Tudor-Ackroyd, 'To Trade or to Halt? That is the Question Confounding Global Markets as Stock Indexes Plunge amid Pandemic' (*South China Morning Post*, 24 March 2020), scmp.com/business/markets/article/3076643/trade-or-halt-vexing-question-confounding-global-markets-stock (reporting that the Colombo and the

Should have they stayed closed until the end of lockdowns? Until levels of economic uncertainty are back to ‘normal’?

To have an impact, stock exchange shutdowns would likely have had to go on for weeks. However, if you suppress investors’ liquidity needs for such a long period, the downward pressure once the stock exchange reopens is even stronger. Worse, if a shutdown does not extend to all or a great majority of world stock exchanges (which is highly unlikely), by shutting down their domestic stock exchanges, policymakers would send the message that such exchanges may shut down for weeks in the event of an emergency: investors, both domestic and offshore, would have to factor in a new kind of illiquidity risk, which in turn would make it less attractive to hold shares listed on the stock exchanges of those countries and therefore require investors to rebalance their portfolios. Again, once the shutdown ends, this additional reason for selling would increase the downward pressure on prices. In addition to the temporary liquidity shock, the demand for shares listed on shutdown stock exchanges would decrease for the longer term as well, raising firms’ cost of capital.

In truth, however, at least in Europe all of this is financial regulation fiction: as Consob clarified,[22] individual regulators in Europe lack the power to shut down an entire stock exchange. Even a shutdown through an emergency law by a member state government would be unlikely to apply to trading activity on foreign trading venues, where that member state’s shares could well continue trading: an extraterritorial ban would likely be against EU rules, very difficult to enforce, or

Manila stock exchanges shut down for a few days in mid-March and recorded heavy losses on the day the reopened).

[22] See Consob (n 19).

both. The only effect of such an emergency law would thus be of reducing, but not halting, trading. That would have a strong negative impact on liquidity, increase volatility, and raise the cost of executing transactions. The symptoms of panic selling would still be visible and the lower trading volumes would even amplify them.

Does that mean that the EU should amend its regulations on trading venues to grant regulators the power to shut down exchanges in times of severe crisis? We hope the arguments developed above are sufficient to support a negative answer to this question.

4. Conclusion

As they did in previous crises, securities regulators have issued bans on short selling in the face of sharp drops in stock prices, despite sound theoretical arguments and consistent empirical evidence justifying the proposition that these measures are pointless, if not counterproductive. But at least it is reassuring that, so far, regulators have not seriously considered a full shutdown of stock exchanges as a response to the current crisis. As regards both short selling bans and stock exchange shutdowns, the old say 'don't shoot the messenger' holds. This rule should apply to messengers motivated by greed no less than to others, and to messengers carrying bad news no more than to those bringing good ones: after all, how rational would it be to punish a doctor that diagnoses a serious disease but applaud one that issues a clean bill of health? Or to refuse paying for the former's services, on account that in this way they would be making money out of the misfortune of their patients?

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17. Fixing the core of EU capital markets legislation during the pandemic: temporary exercises or long-term path?

Filippo Annunziata & Michele Siri

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1. Pandemic and Quick Fixes: facing the emergency

As discussed in a previous contribution on this topic,[1] in the wake of the pandemic, also EU Capital Markets Legislation took up the task of contributing to the mitigation of the effects of the crisis. As the pandemic progressed further, discussions and debates were triggered in relation to almost all relevant areas of that legislation, thus paving the way to major long-term reforms. On another but related plan, the Commission took the

[1] See our Chapter in Christos V. Gortsos & Wolf-Georg Ringe (eds), *Pandemic Crisis and Financial Stability* (EBI 2020), ssrn.com/abstract=3607930.

lead in proposing the adoption of some urgent measures that go under the title of ‘Capital Markets Union Recovery Package’. Contingent, extraordinary measures thus combine with a long-term view of the future of EU Legislation in the field of capital markets. The crisis is hitting hard but is also providing lessons to be learned.

One of the core areas affected by this phenomenon is, naturally, the huge Capital Markets Union project. Its stated objective is to allow capital to flow in the European Union while enhancing consumers and investors protection, driving supervisory convergence throughout Member States, and supporting the proper functioning of the internal market.[2] As the pandemic shed shadows on the possible achievement of these objectives, the EU Commission spurred the adoption of two ‘quick fixes’ of MiFID II and Prospectus Regulation, with the aim to make investments in the real economy easier and provide European companies with a faster track for their recapitalisation.[3] These interventions ease companies’ administrative burdens both in terms of money and time consumption. More specifically, the

[2] EC, ‘A Capital Markets Union for people and businesses-new action plan’ (Communication from the Commission to the Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, 24 September 2020) COM(2020) 590 final.

[3] Directive (EU) 2021/338 of the European Parliament and of the Council of 16 February 2021 amending Directive 2014/65/EU as regards information requirements, product governance and position limits and Directive 2013/36/EU and (EU) 2019/878 as regards their application to investment firms, to help recovery from the COVID-19 crisis [2021] OJ L 68, 14 (hereinafter ‘MiFID II Quick Fix’); Regulation (EU) 2021/337 of the European Parliament and of the Council of 16 February 2021 amending Regulation (EU) 2017/1129 as regards the EU Recovery prospectus and targeted adjustments for financial intermediaries and Directive 2004/109/EC as regards the use of the single electronic reporting format for annual financial reports, to support the recovery from the COVID-19 crisis [2021] OJ L 68, 1 (hereinafter ‘Prospectus Quick Fix’).

quick fixes to MiFID II aim to provide relief to investment services providers, by simplifying some of its burdens, calibrating investors' protection with targeted amendments. The quick fixes to the Prospectus regulation aim to reduce costs for issuers and financial intermediaries in raising capital from the market. The amendments also introduce a new, so-called European Union Recovery Prospectus: a tool shaped to alleviate administrative costs and facilitate the collection of capitals on the market.[4]

While the above interventions share the overarching goal of simplification, they also have another common feature: they are all exceptional, and some of them are temporary. However, we believe that they should not be considered as an entirely fleeting exercise of a legislator put under pressure by the extraordinary situation of the pandemic. Indeed, by looking at the developing debate on EU Capital Markets legislation – that the pandemic is accelerating - some of these exceptional measures are likely or bound to produce longer-term effects. The recently activated discussion on the possible revision of MiFID II, the wide debate on SMEs and their access to capital markets, and other ongoing consultations on various areas of EU Capital Markets law seem to indicate a trend towards a more balanced and proportionate approach. The pandemic seems, therefore, to be the occasion for a wider, more articulate stimulus on further areas of intervention, and some of the key concepts being tested in various contexts are: proportionality; simplification; loosening

[4] See, for a comprehensive analysis, Christos V. Gortsos and Marialena E. Terzi, 'The Prospectus Regulation (Regulation (EU) 2017/1129) and the Recent Proposal for an EU Recovery Prospectus: Elements of Continuity and Change with the Past and the Way Forward' (2020) European Banking Institute Working Paper Series no 79 / 2020, ssrn.com/abstract=3742863.

of unnecessary burdens; more attention to a careful cost-benefit analysis. If this trend is confirmed, EU Capital Markets Legislation might, therefore, indeed become more user-friendly and proportionate, and the pandemic be remembered as the starting point of such a wider process.

1.1. Fixing MiFID II: the main amendments to the Directive

The original regime adopted by the European Union on investment services and activities was the one carried out by the Investment Services Directive of 1993 (Directive 93/22/EEC), which was followed by MiFID I (Directive 2004/39/EC).[5] Both Directives helped to increase the competitiveness of EU capital markets, supporting the creation of a single market for investment services and activities. MiFIR[6] and MiFID II later reinforced rules applicable to securities markets to increase transparency and foster competition, and strengthened the protection of investors by introducing stricter requirements on the organisation and conduct of market participants.

As the entire MiFID II package (an awesome multi-layered structure, of extraordinary complexity) is currently under review, the pandemic highlighted several weaknesses of its provisions. In this context, the EU Commission saw an opportunity to cut the wait for a thorough review of the

[5] Directive 2004/39/EC of the European Parliament and of the council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC [2004] OJ L 145, 1.
[6] Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 [2014] OJ L 173, 84.

discipline and introduced some urgent amendments with the MiFID II Quick Fix.

The Recitals to the MiFID II Quick Fix acknowledge the need to simplify certain aspects of the legislation and reduce administrative burdens and regulatory complexity. While doing so, they also declare the necessity to re-calibrate investor protection: both objectives now also inspire the broader and longer-term revision of the MiFID II.[7]

To ease some of the burdens on the provision of investment services and activities while also better-calibrating investors protection according to their expertise, MiFID II Quick Fix targets (i) compliance duties and (ii) exemptions.

Specifically, Article 16a of the Quick Fix exempts investment firms from product governance requirements in two cases. Namely, (i) where the investment service it provides relates to bonds with no other embedded derivative than a make-whole clause; or (ii) where the financial instruments are marketed or distributed exclusively to eligible counterparties. In the first case, investors' protection is granted by the presence of a make-whole clause. Therefore, in case of early redemption of a bond, this clause ensures that the issuer pays the investor holding the bond an amount equal to the sum of the net present value of the remaining coupon payments expected until maturity and the principal amount of the bond to be redeemed. In the second case, the financial instruments are exclusively marketed or distributed to investors assuming that they have sound knowledge and expertise.

In the same context, the Quick Fix targets the relationship between investment firms and third parties providing research

[7] MiFID II Quick Fix, recitals 2 and 3.

activities in relation to portfolio management. The requisites for the provision of research activities set out by MiFID are to be considered satisfied if a written agreement is in place between the investment firm and the research provider, clearly identifying the related costs, and proper information is granted to clients. The wording of the Article narrows the scope of this provision to the extent research activity is performed in relation to issuers with less than EUR 1 billion capitalisation during the previous 36 months. The purpose of this intervention is to increase the visibility of issuers falling below the threshold and their chances to access market liquidity.[8]

Furthermore, according to the new Article 29a, the costs and charges of investment services shall no longer be disclosed to professional clients and eligible counterparties, except when providing investment advice or portfolio management. When investment services are provided to professional clients, the suitability assessment and reporting duties as laid down in Articles 25(2) and 25(6) MiFID II will no longer be required, unless the client differently requests.[9]

The amendments also alleviate reporting duties for trading venues, systematic internalisers and other execution venues. MiFID II places upon trading venues and systematic internalisers several reporting requirements. By the same token, investment firms must report information to clients regarding transactions executed on their behalf. The MIFID II Quick Fix alleviates some of these reporting duties until February 2023. It is interesting to note that the justification for these alleviations does not exclusively lie in the exceptionality of the pandemic situation, but also in the assumption that most of these reports

[8] MiFID II Quick Fix, Article 16a.
[9] MiFID II Quick Fix, Article 29a.

are rarely read or taken into account by investors and market participants.[10]

The Quick Fix also broadens the scope of the exemptions provided by Article 2 of MiFID II and particularly of those applicable – under paragraph 1, letter j) – to persons whose activity is performed as ancillary to their main business. These persons will no longer be required to annually notify the National Competent Authority of their intention to make use of such exemption. Instead, they will be required to report to the National Competent Authority how they have assessed their eligibility to make use of the exemption. In relation to this, the Quick Fix demands the European Commission to set out more precise criteria according to which a specific activity is to be considered ancillary to the main business.[11]

In addition, according to Article 16a(10), financial entities set-up within predominantly commercial groups in order to carry out trading activity for the group shall be granted a hedging exemption from the position limits regime. The rationale is to enhance such activity when it aims to reduce risks. Once again, this is now established as a temporary Quick Fix. However, some of these provisions disclose a more long-sighted vision: one of these is the exemption from the position limits regime demanded for participants in commodity markets acting as market makers, which, according to some, proved to limit markets participants' capabilities. Lastly, the Quick Fix

[10] MiFID II Quick Fix, Recital 7.

[11] MiFID II Quick Fix, Article 1. By 31 July 2021, the Commission shall adopt a delegated act in accordance with Article 89 in order to supplement the Directive by specifying the criteria for establishing when an activity is to be considered as ancillary to the main business at group level.

delegates to the Commission the task of developing and implementing legislation in this respect.[12]

The Quick Fix also supports certain objectives of the European Green strategy: it sets out that investment firms shall provide information to clients in electronic format unless retail or potential retail clients have requested them on paper.[13] More broadly, as can also be seen in the MiFID II Review process, there seems to be a clear tendency towards using more extensively electronic formats and electronic means of communication. While the pandemic initially imposed this due, *inter alia*, to social distancing, the trend seems to be here to stay.

2. The way forward: from Quick Fixes to long-term amendments. The debate on the revision of MiFID II

The MiFID II review process started before the breakout of the pandemic, and its final outcome is, for now, very difficult to identify. There are, however, some similarities between the approach taken by the Quick Fix and the wider revision of MiFID II. One feature is the attempt to apply rules on a more proportionate basis, taking into account the need of adopting a more granular approach in relation to investors' protection. In the Quick Fix, this takes the form of targeted interventions on specific rules of MiFID II, whereas in the context of the MiFID II review consultation, stakeholders also suggested the introduction of a new clients' category: semi-professional investors.[14] Therefore, there seems to be the need to revise the

[12] MiFID Quick Fix, Recital 19.
[13] MiFID II Quick Fix, Article 16a, para 4.
[14] EC, 'Consultation document: Review of the MiFID II/MiFIR regulatory framework' (17 February 2020), ec.europa.eu/info/files/ 2020-mifid-2-mifir-review-consultation-document_en.

old categories of retail/professional clients/qualified counterparties that were introduced in the early 2000s and remained thereafter basically unchanged. More flexibility is now needed, resulting in either a more proportionate application of existing rules, or a new categorisation of the clients, or a combination of the above.

Product governance rules – one of the true novelties of MiFID II – are also under the spotlight. As product governance aims to reduce cases of misselling, stakeholders – and distributors, more precisely – identified various inefficiencies that are now being considered in the process of the revision of the Directive: most participants to the consultation phase complained about the lack of information regarding certain products and, more in general, about their usefulness with respect to the individual suitability assessment to undertake.[15]

Equity research rules were also targeted as inadequate. The SMEs universe, in particular, took the hit for their improperness: research showed an overall decline in the European Union and SMEs more clearly paid the price. In this regard, the Quick Fix now provides a first response, addressing the topic as described above.

In relation to the revision of MiFID II, stakeholders pointed out the risks arising from the development of electronic platforms not authorised as trading venues that offer functionality similar to a multilateral system for the matching of multiple buying and selling interests. These platforms match trading interests on a bilateral basis on an automatic basis, so they do not formally meet the definition of an MTF or an OTF (let alone that of a Regulated market). For these reasons, stakeholders complained

[15] ibid Section 4.

of competitive distortions and claimed a broader definition of trading venues or multilateral systems.

A broader theme that does not go unnoticed regards ‘digitalisation’. The switch to electronic format in compliance with reporting duties is a clear option of MiFID II Quick Fix, and it seems to be an amendment destined to be retained. In this respect, as technology neutrality is one of the guiding principles of the Commission’s policies, no mandatory technology will be imposed, as it would prove burdensome for parties involved.

Investors and intermediaries in the European Union struggle to build a consolidated view of where financial instruments are traded, how much is traded, and at what price. In this regard, a single price comparison tool consolidating trading data across the EU, referred to as the Consolidated Tape (CT), has been identified by lawmakers as a useful means to help brokers to locate liquidity at the best price available. While this has been announced several times in the past, the project never actually took off, nor has it been implemented, also because of the high level of investments involved in its realisation. ESMA provided the Commission with positive comments from stakeholders and welcomed the tool: a European CT could be one major step towards ‘democratising’ access to ‘market data’. It may prove useful also for exchange-traded funds (ETFs), bonds or other non-equity instruments. In addition, it would influence modification to transparency and investors information rules. It remains to be seen whether the recovery after the pandemic will provide a stimulus in this direction.

Lastly, stakeholders requested the Commission to deal with Spot FX contracts and consider addressing the regulatory gap that does not recognise them as falling within the definition of financial instruments.

3. Prospectus: the long and winding road towards simplification

European lawmakers created a robust legislative framework with respect to the drawing up, approval and distribution of the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market situated or operating within a Member State with Directive 2003/71/EC[16]. The stated objectives of the Directive were to ensure investors protection and market efficiency, but ultimately achieved an insufficient level of harmonisation. The Prospectus Regulation was introduced in 2014 to provide maximum harmonisation by pursuing three main objectives: simplification, investor protection, and better coordination between prospectus and other disclosure tools contemplated by EU Legislation.

The Prospectus Regulation lowered the threshold triggering the requirement to publish a prospectus. While the Directive applied the requirement for offers of securities to the public of over EUR 5 million, the Regulation set the new threshold at EUR 1 million, thus significantly broadening its scope.[17] Nonetheless, the scope of this threshold was narrowed: Member States may not set a lower threshold but still retain the possibility to provide other disclosure requirements.

Like the Directive, the Regulation exempted credit institutions from publishing a prospectus for non-equity securities issued in a continuous or repeated manner, if the total aggregated

[16] Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC [2003] OJ L 345, 64.
[17] Respectively Directive 2003/71/EC, Article 1(2), point j); and Prospectus Regulation, Article 1(3).

consideration in the EU for the securities offered is less than 75 million in 12 months, provided that those securities are not subordinated, convertible or exchangeable and do not give the right to subscribe for or acquire other types of securities and are not linked to a derivative instrument. Nonetheless, while under the prospectus Regulation the issuers and/or offerors shall rely on exemptions to the public offer and listing requirements, under the Directive such securities were exempted from the scope altogether.[18]

Prospectus Regulation did not significantly broaden the 'safe havens' regime but included offers of securities for a total consideration of less than EUR 100,000. The Regulation raised the threshold for the exemption to publish prospectus for securities up to 20% but imposed two additional requirements: shares resulting from the conversion or exchange shall represent, over a period of 12 months, less than 20% of the number of shares of the same class already admitted to trading on the same Regulated Market. In addition, the threshold does not apply for convertible and exchangeable securities when: the prospectus is drawn up in accordance with the Prospectus Regulation or Directive upon the offer to the public or admission to trading on a Regulated Market of the securities giving access to the shares, and the resulting shares qualify as CET 1.[19]

The disclosure requirements provided under Prospectus Regulation may prove burdensome for issuers. This effect might even be amplified for SMEs, which struggle to grow and, thus, might be more affected by these duties. Because of this, EU lawmakers provided a bespoken tool for SMEs: the

[18] Gortsos and Terzi (n 4) 6.
[19] ibid 8.

European Union Growth Prospectus. The EU Growth Prospectus is a standardised document whose content, provided by Annex IV of the Prospectus Regulation, is significantly reduced. Such a tool shall allow SMEs to access capital markets and collect financing more easily.[20]

In an effort to gather suggestions in order to provide SMEs with easier access to capital markets, the Commission also set up a technical expert stakeholder group on SMEs (TESG). Among other issues, the TESG addressed the possibility to simplify listing requirements and enhance access to capital for micro enterprises.[21]

In the wake of the pandemic, the Prospectus Quick Fix was entrusted (differently from MIFID) to a regulation: this specific, urgent intervention shares some of its goals with the MiFID II Quick Fix.

In the Prospectus Quick Fix, the task of reaching the objectives is entrusted to a new instrument: the European Union Recovery Prospectus (Recovery Prospectus). Its stated goal is to allow fast companies recapitalisation facilitating equity funding.
The circumstances under which the Prospectus Quick Fix was issued shaped its characteristics and required few introductory statements. As for certain provisions of the MiFID II Quick Fix, the regime will be temporary: Recovery Prospectuses approved

[20] Prospectus Regulation, Article 15.
[21] The TSEG Report was delivered in May 2021 and contains a list of suggestions and recommendations for SEMs. Technical expert stakeholder group (TESG) meeting minutes and agenda are available at: ec.europa.eu/transparency/expert-groups-register/screen/expert-groups/consult?do=groupDetail.groupDetail&groupID=3735&news=1.

before 31st December 2022 will be valid for a 12 months limited period of time.[22]

Besides timing, the Recovery Prospectus has a specific subjective and objective defined scope. According to Article 14a, the Recovery Prospectus may be drawn up in the case of an offer of shares to the public or of an admission to trading of shares on a regulated market and only by issuers: (i) whose shares have been admitted to trading on a regulated market, or (ii) whose shares have already been traded on an SME Growth Market for the last 18 months, and that issue shares fungible with existing shares previously issued; or (iii) offerors of shares admitted to trading on a regulated market or an SME Growth Market continuously for the same period of time.

Issuers, in any case, may employ this tool only when offering a number of shares that represents: (i) no more than 150% of the number of shares already admitted to trading on a regulated market or an SME growth market, (ii) together with the number of shares already offered via a Recovery Prospectus over a period of 12 months, on the date of approval of the Recovery Prospectus.[23]

The Recovery Prospectus is available to companies that have already complied with periodic and ongoing disclosure requirements: the fact that information has already been published justifies a lighter document.

After having defined the Recovery Prospectus scope, the Prospectus Quick Fix targets its content. The Recovery

[22] Prospectus Quick Fix, Article 1, para 9.
[23] Prospectus Quick Fix, Article 14a.

Prospectus is an extremely simplified document, of a maximum length of 32 pages, references excluded.

More specifically, Article 14a sets out that the Recovery Prospectus shall include essential and relevant information for investors, describing concisely and in a comprehensible manner: (i) the prospects and financial performance of the issuer; (ii) significant changes in its financial and business position occurred since the end of the last financial year; (iii) its financial and non-financial long-term business strategy and objectives; (iv) at least 400 words regarding the business and financial impact of COVID-19 pandemic on the issuer and its anticipated future impact; (v) essential information on the shares, including rights attached and any related limitations; (vi) reasons for issuance and its impact on the issuer, including its overall capital structure, a disclosure of capitalisation and indebtedness, a working capital statement and the use of proceeds.[24]

There is also the need for a two A4 sized pages summary divided in four sections: (i) an introduction, including warnings and the date of approval of the Recovery Prospectus; (ii) key information on the issuer, including a 200 words reference describing the COVID-19 pandemic business and financial impact on the issuer; (iii) key information on the shares, rights attached and any limitation; (iv) key information on the offer of shares to the public and/or the admission to trading on a regulated market.

These content requirements are consistent with the Recovery Prospectus *motto*: easy to draw up, comprehend, and control. The latter function is performed by NCAs, within a reduced

[24] Article 14a, para 2.

timespan: the publication of the Recovery Prospectus must be authorised within seven working days. Issuers will have to inform the NCA at least five working days before the date envisaged for the submission.[25]

Furthermore, the Prospectus Quick Fix amends Article 23 of the Regulation providing investors who have agreed to purchase or subscribe securities with the right to withdraw their acceptances within three working days when a supplement is published. Such period may be extended by the issuer/offeror.

In any case, distributors shall inform investors of the possibility of a supplement being published. If investors have the right of withdrawal, the distributor shall contact them within the end of the first working day following the publication. If securities are purchased or subscribed directly from the issuer, it is the latter that must comply with these rules. Eventually, the Recovery Prospectus may not be employed to transfer from a SME Growth Market to a Regulated Market.[26]

Meanwhile, the UK paves the way for Prospectus deregulation: proposals under discussion relate to differentiating the requirements between access to Regulated Markets and public offerings, changing exemption thresholds in relation to the type of transaction, and using alternative listing documents.[27]

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[25] Prospectus Quick Fix, Article 1, para 6.

[26] Prospectus Quick Fix, Article 1, para 8.

[27] Financial Conduct Authority, 'FCA welcomes Lord Hill's Listing Review Report' (Statement, 3 March 2021), fca.org.uk/news/statements/fca-welcomes-lord-hills-listing-review-report. The Lord Hill's Listing Review Report is available on the same webpage.

4. Working on the huge arsenal of EU Capital Markets Legislation: lessons from the pandemic

As a consequence of the pandemic, Capital Markets Legislation in the EU is once again in the wake of a process of revision and update: one may wonder, indeed, whether this is something exceptional. Capital Markets have been a gigantic working site that has been kept open and ongoing for at least the last 30 years. Financial crisis, market failures, but also market and technological developments keep the pace of innovation pretty high. This is not the right venue to conduct an overview of all the topics that are currently being discussed: rather, we would like to point out how, out of the pandemic experience, there seem to be some trends emerging, destined to survive after the emergency.

As already noted, one first, clear signal is the trend towards a certain simplification of the existing regulation: the Quick Fixes, and many of the current discussions and consultations on different areas of EU Capital markets legislations, seem to point in that direction. This trend is also supported by technological evolution allowing for the development of various regulatory and supervisory tools that provide greater space for simplification in the use of traditional legal forms (written agreements, consensus in writing; documentation in paper form etc.).

Simplification also means applying proportionality on a more extensive and robust basis: while the ‘one-size-fits-all’ approach has never been the standard in Capital Markets Legislation, the traditional view in this respect is now becoming obsolete. As anticipated, the typical distinction between retail and professional clients (valid, amongst other, in the context of MiFID; AIFMD; Prospectus, etc.) seems to be incapable of capturing the different levels of experiences that investors share on the market, whereby to simply turn 'on and off' certain provisions depending on one of the two status is a bit unsatisfactory. Indeed, more different shades of grey are required so as not to overburden market players and investors alike with unnecessary requirements and over-comprehensive rules. The need to introduce at least an intermediate level of investors (semi or quasi-professional) goes in this direction, but also that of better identifying and classifying clients in one of the existing categories. Some EU Member States already moved, well before the pandemic, in this direction, in certain areas under National law.[28]

A second, very clear trend is that which is gradually leading to the development of a comprehensive set of Capital markets regulations aimed at targeting SMEs and their specific needs. Whereby, until now, SMEs are considered as exceptions, and capital markets legislation is indeed targeting mostly large-caps, this approach might be short-lived. Markets look nowadays, indeed, pretty different: according to the latest report from ESMA on the functioning of European Growth Markets, more than 74 per cent of all the companies whose instruments are traded in the EU are, indeed, SMEs.[29] This means, in other words, that what was once considered as an exception, is now becoming the standard, as the entire EU Region seems to be developing in a direction where capital

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[28] Interesting information can be found in the document by ESMA, 'ESMA's opinion to the European Parliament, Council and Commission and responses to the call for evidence on the functioning of the AIFMD EU passport and of the National Private Placement Regimes' (30 June 2015) 2015/ESMA/1235, esma.europa.eu/sites/default/files/library/2015/11/2015-1235_opinion_to_ep-council-com_on_aifmd_passport_for_publication.pdf.

[29] ESMA, *MiFID II review report on the functioning of the regime for SME Growth Markets* (25 March 2021), ESMA70-156-4103.

markets are populated mostly by small and medium enterprises, as we define them today. In considering this trend, one should also realise that SMEs are active in sectors that are likely to encounter the highest level of development in the future, whereby larger EU players (the ones that will remain at least) will be operating in more traditional sectors, thus being subject to a faster process of obsolescence. Therefore, it might well be that in a not-too-distant future, the current percentage of 74 per cent significantly increases. The time might also be ripe for amending the structure itself of EU Capital markets legislation: instead of considering SMEs as an exception, thereby carving them out from specific provisions, with a case-by-case approach - with the risk of generating confusion and difficulties of coordination - the approach might need to be re-considered. EU Capital Markets legislation might thus become one that is conceived for, and that targets, SMEs, providing a uniform, comprehensive regime for the latter, whereby reserving certain, specific rules, only to larger corporations on the market (gradually becoming more and more an exception).

Two further topics that emerge from current debates are ultimately linked to broader phenomena, cross-sectoral in nature, which extend well beyond financial regulation: i.e., environmental issues, and technology. The pandemic is clearly showing, in all areas, how close the Planet is moving towards challenging its own sustainability and, at the same time, how pervasive technology has become. The EU Commission recently took the lead in both areas by providing comprehensive legislative proposals and reforms in most of these areas. It is not a chance that the pandemic proved to be an accelerator in this respect: Non-Financial disclosure, ESG Finance, Taxonomy for Financial products, on the one side, the Digital Finance Packages, and the recent proposal for a regulation on artificial intelligence, on the other, are all ground-breaking initiatives that were carried on and announced during the crisis.

What is striking in both respects is not just the specific weight of the measures being enacted, but the wide, comprehensive debate that, in a comparatively short period of time, has been triggered, bringing right to the forefront of the economic, academic, political discussion, topics that, until recently, were either unknown or merely reserved to the knowledge of very few. As always, from even the worst experiences, lessons can indeed be learned. The pandemic is showing the way towards a more sustainable, more proportionate, and calibrated EU Capital markets legislation. Small steps are combined with huge leaps ahead, but in a relatively short period of time the face of that legislation may turn out to be slightly different from the one that the EU delivered in the past. Whether it will be more friendly for all stakeholders and market participants, combining proportionality with adequate safeguards of investors protection and market integrity, still remains to be seen.

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